No. 75-1285

In the Supreme Court of the United States

OCTOBER TERM, 1975

Supreme Court, U. S.
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UNITED STATES OF AMERICA, PETITIONER

v.

PENN SECURITY LIFE INSURANCE COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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No.

UNITED STATES OF AMERICA, PETITIONER

v.

PENN SECURITY LIFE INSURANCE COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Claims in this case.

OPINION BELOW

The opinion of the Court of Claims (App., *infra*, pp. 1a-60a), incorporating the opinion of the trial judge with minor changes and some additions, is reported at 524 F.2d 1155.

JURISDICTION

The judgment of the Court of Claims was entered

on October 22, 1975 (App., *infra*, pp. 1a, 60a).[1] By order dated January 15, 1976, the Chief Justice extended the time for filing a petition for a writ of certiorari to and including March 20, 1976. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

QUESTION PRESENTED

Section 801(a) of the Internal Revenue Code of 1954 defines a "life insurance company" as an insurance company whose life insurance reserves comprise more than 50 percent of its "total reserves," as that term is defined by Section 801(c).

The question presented is whether an insurance company which assumed the ultimate insurance risk on accident and health insurance ceded to it by another company under a reinsurance agreement is required for federal tax purposes to include in its total reserves the reserves attributable to such non-life insurance so as to render it ineligible for preferential tax treatment accorded to a "life insurance company," or whether, as the Court of Claims held, such reserves are attributable to the ceding company which temporarily holds the premiums paid in advance on such policies.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 801 [as amended by Sec. 2(a), Life Insur-

[1] The precise amount of the judgment will be determined in further proceedings under Rule 131(c) of the Court of Claims.

ance Company Income Tax Act of 1959, 73 Stat. 112]. DEFINITION OF LIFE INSURANCE COMPANY.

(a) *Life Insurance Company Defined.*—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—

(1) its life insurance reserves (as defined in subsection (b)), plus

(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves (as defined in subsection (c)).

(b) *Life Insurance Reserves Defined.*—

(1) *In general.*—For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life in-

surance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

* * * * *

(c) *Total Reserves Defined.*—For purposes of subsection (a), the term "total reserves" means—

(1) life insurance reserves,

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) all other insurance reserves required by law.

The term "total reserves" does not include deficiency reserves (within the meaning of subsection (b)(4)).

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.801-3 *Definitions.*

* * * * *

(e) *Unearned premiums.* The term "unearned premiums" means those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Such term includes all unearned premiums, whether or not required by law.

* * * * *

§ 1.801-5 *Total reserves.*

* * * * *

(b) *Reserves required by law defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

* * * * *

STATEMENT

Respondent was incorporated under the laws of Missouri as a wholly-owned subsidiary of Aetna Finance Company, the assets of which are now owned by a wholly-owned subsidiary of International Telephone & Telegraph Corporation known as ITT Aetna Corporation (App., *infra*, p. 30a). Aetna made consumer loans through subsidiaries operating more than 200 finance company offices in approximately 25 states (App., *infra*, p. 3a). In connection with its loan transactions, it was common for Aetna's borrowers to apply for and receive credit life insurance policies (or group insurance certificates), including health and accident benefits, from one of three insurance companies: Old Republic Life Insurance Company, Pilot Life Insurance Company,

and National Fidelity Life Insurance Company (App., *infra*, pp. 3a-4a).

Under the life insurance provisions of these policies, the insurer was required to pay Aetna any outstanding balance of the loan in the event of the insured debtor's death. The accident and health (A&H) provisions of the policy required the insurer to pay loan installments falling due while the insured was totally disabled and unable to work. The terms of the policies were coextensive with the term of the related loan (App., *infra*, p. 4a).

A&H insurance was sold to Aetna's borrowers only together with life insurance. However, the amounts of the A&H insurance premiums were separately stated. The premiums were required to be paid in full by the insured debtor at the inception of the policy term (App., *infra*, pp. 33a, 39a-40a).

Respondent was organized by Aetna for the purpose of reinsuring the policies issued to Aetna's loan customers by Old Republic, Pilot, and National Fidelity. During 1963-1965, the taxable years at issue, respondent's business primarily consisted of such reinsurance. Respondent conducted its reinsurance business pursuant to reinsurance agreements ("treaties") with Old Republic, Pilot, and National Fidelity during each of the years in issue (App., *infra*, pp. 3a, 4a, 40a).

Under its reinsurance treaties with these companies, respondent assumed the entire insurance risk by agreeing to reinsure 100 percent of the liability of each company with respect to life insurance and A&H insurance issued to Aetna and its borrowers.

In exchange for assuming the insurance risk, respondent received the premiums less a 2 percent commission to the issuing companies.[2] The treaties provided for the payments of reinsurance premiums with respect to life insurance coverage as they were received by the issuing companies. However, the A&H insurance premiums were paid to respondent on a monthly basis and such payments represented that portion of the premiums allocable to the prior month's coverage (App., *infra*, pp. 4a-5a, 40).

Respondent was generally entitled to receive 98 percent of the premiums earned with respect to credit A&H insurance in force during the previous month. Thus, for example, if the issuing company received a $360 A&H premium on January 1, 1963, with respect to a 36-month policy, 1/36 of this premium ($10) would be allocable to coverage for the month of January and $9.80 would be paid over to respondent during the month of February (App., *infra*, pp. 5a, 40a-41a). Under the reinsurance treaties, respondent was liable to the issuing companies for the benefits covered by reinsurance to the same extent as the issuing companies were liable to the persons insured for such benefits. As a result, whenever a claim was made under a policy that the issuing company reinsured with respondent, respondent was required to consider it to be a claim for the full amount of reinsurance on the policy (App., *infra*, pp. 42a-43a).

For each of the years 1963, 1964, and 1965, respondent filed an annual statement with the Mis-

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[2] Old Republic retained an 11 percent commission (App., *infra*, p. 40a).

souri Division of Insurance. These annual statements did not reflect any unearned premium reserves with respect to policies issued by Old Republic, Pilot, and National Fidelity, or with respect to respondent's reinsurance treaties with those companies (App., *infra*, pp. 46a-47a). After audits of respondent by the Missouri Division of Insurance in 1965 and 1969, respondent was not required to establish unearned premium reserves with respect to A&H premiums received by Old Republic, Pilot, and National Fidelity, or with respect to reinsurance premiums received by respondent under its A&H reinsurance treaties with those companies (App., *infra*, pp. 47a-48a).

For each of its taxable years 1963, 1964, and 1965, respondent computed its taxable income on its federal income tax returns as a life insurance company under Section 802 of the Code. On audit, the Commissioner of Internal Revenue determined income tax deficiencies, asserting that respondent was not entitled to deduct certain losses in connection with the computation of its reserves (App., *infra*, pp. 8a, 57a). After respondent filed a petition in the Court of Claims seeking a refund of the deficiencies it paid, the Commissioner determined additional deficiencies for 1963, 1964, and 1965, based upon his conclusion that during those years respondent did not qualify for the preferential tax treatment accorded to a life insurance company. The ground of the Commissioner's determination was that respondent's life insurance reserves did not comprise more than 50 percent of its total reserves as required by Section 801(a) of the Code. The Commissioner's

determination was based upon his inclusion of the A&H reserves in respondent's total reserves (App., *infra*, pp. 8a, 57a-58a).

Respondent thereupon paid the additional deficiencies and sought its refund in the suit it had already commenced in the Court of Claims (App., *infra*, pp. 8a-9a).[3] With one judge dissenting, the Court of Claims adopted its trial judge's recommended decision that the A&H insurance reserves could not be included in respondent's total reserves as "unearned premiums" under Section 801(c)(2) of the Code because the various issuing companies were in physical possession of the unearned portion of the premiums paid in advance on the A&H policies under the reinsurance treaties (App., *infra*, pp. 13a-21a). The court concluded that respondent did not have to include the A&H insurance reserves as part of its total reserves because each monthly payment of A&H premiums made to respondent by the issuing companies represented premiums allocable to coverage for the prior month so they were not "unearned premiums" within the meaning of Section 801(c)(2) of the Code. In so holding, the court rejected the contrary conclusion on identical facts of the Seventh

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[3] The provisions of the Old Republic treaty differed from those of the Pilot and National Fidelity treaties as to the effect of termination upon insurance in force. In order to dispense with the need to consider the legal effect, if any, of such differences and because the A&H reserves with respect to the Old Republic treaty made no difference to the outcome of this case, the government agreed in the court below that they could be disregarded in computing respondent's total reserves (App., *infra*, p. 38a).

Circuit in *Economy Finance Corp.* v. *United States*, 501 F.2d 466, certiorari denied, 420 U.S. 947 (App., *infra*, pp. 13a-19a).

The court also ruled that respondent was not required by Missouri law to establish reserves for the disability insurance, so that they were not "other insurance reserves required by law" within the meaning of Section 801(c)(3) of the Code. Accordingly, the court held that respondent qualified as a "life insurance company" under Section 801(a) of the Code (App., *infra*, pp. 21a-22a).

The dissenting judge argued that the Seventh Circuit in *Economy Finance Corp.* v. *United States*, *supra*, construed Section 801(a) "in a sound and persuasive fashion" (App., *infra*, p. 28a). In this view, the A&H insurance reserves should be included in respondent's reserves as "unearned premiums" under Section 801(c)(2) of the Code because "it has arranged to have [such reserves] ostensibly carried for it by others, though in reality, it bears the risk of loss itself" (App., *infra*, p. 29a). In so concluding, the dissenting judge agreed with the conclusion of the Seventh Circuit in *Economy Finance* that non-inclusion of such reserves "completely frustrates the purpose Congress ha[d] in mind in prescribing the [50 percent] test [of Section 801(a)]" (App., *infra*, p. 29a).

REASONS FOR GRANTING THE WRIT

As the Court of Claims recognized here (App., *infra*, pp. 15a-19a), and in its companion decision

in *Consumer Life Insurance Co.* v. *United States*, 524 F.2d 1167, 1174, petition for a writ of certiorari pending, No. 75-1221, its holding directly conflicts with *Economy Finance Corp.* v. *United States*, 501 F.2d 466 (C.A. 7), certiorari denied, 420 U.S. 947, which was followed in *First Railroad & Banking Co. of Ga.* v. *United States*, 514 F.2d 675 (C.A. 5). See also *Superior Life Insurance Co.* v. *United States*, 462 F.2d 945 (C.A. 4). The decision below holding that an insurance company is not required to include in its total reserves those reserves attributable to non-life insurance on which it bears the ultimate insurance risk so that it may qualify for the preferential tax treatment accorded to a "life insurance company" as defined in Section 801(a) of the Internal Revenue Code of 1954, is therefore in conflict with those of two courts of appeals. The issue has substantial impact upon the revenue and has been and continues to be widely litigated. Resolution of the conflict by this Court is therefore essential in order that there be a uniform national rule.

For the reasons we have set forth at pp. 14-21 in our petition for a writ of certiorari in *Consumer Life Insurance Co.* v. *United States*, *supra*,[4] we submit that the economic substance of respondent's reinsurance arrangement, which is typical of those used in the industry, decisively establishes that the A&H reserves are includable in respondent's total reserves as "unearned premiums" under Section 801

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[4] We are serving a copy of our petition in *Consumer Life Insurance Co.* upon counsel for the respondent.

(c)(2). As the Seventh Circuit stated in its contrary decision in *Economy Finance Corp.* v. *United States*, *supra*, in characterizing the role of a company analogous to that of Old Republic, Pilot, and National Fidelity in an arrangement virtually identical to respondent's reinsurance treaty: "[it] performed a banking and clearing-house function and not an insurance function" (501 F.2d at 478). Similarly, the three ceding companies in this case were exposed to no insurance risk and therefore cannot be deemed to have any insurance reserves. The A&H reserves must therefore be included in respondent's total reserves under Section 801(c)(2).[5]

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[5] The Court of Claims' conclusion (App., *infra*, pp. 21a-22a) that respondent was not required under Missouri law to establish a reserve for the A&H insurance does not detract from our argument that the economic reality of the reinsurance arrangement is controlling for federal tax purposes under Section 801(c)(2). See p. 21, n. 7, of our petition for a writ of certiorari in *Consumer Life Insurance Co.*, No. 75-1221.

At all events, we submit that the Court of Claims erred in concluding that Missouri law did not require respondent to establish a reserve for the A&H insurance. In so concluding, the Court of Claims did not undertake an independent analysis of the state statute but premised its conclusion upon the fact that the Missouri insurance administrators did not require respondent to establish reserves with respect to the A&H insurance (App., *infra*, pp. 22a, n. 4, 48a-49a). But under the Missouri statute, Vernon's Ann. Mo. Stat. § 376.410 (1968), the ceding companies were exempt from carrying reserves on the A&H insurance, so that respondent should have established such reserves. Thus, the A&H reserves would be includable in respondent's total reserves on the independent alternative ground that they were "other insurance reserves required by law" under Section 801(c)(3) of the Code. See also Treasury Regulations (26 C.F.R.), Section 1.801-5(b).

CONCLUSION

For the reasons stated above and in our petition in *Consumer Life Insurance Co.*, the petition for a writ of certiorari should be granted.[6]

Respectfully submitted.

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Solicitor General.

SCOTT P. CRAMPTON,
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Attorneys.

MARCH 1976.

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[6] The Court may deem it appropriate to hold this case pending its disposition of *Consumer Life Insurance Co.* The two reinsurance arrangements of that case are respectively identical to those considered by the conflicting decisions of the Seventh and Fifth Circuits in *Economy Finance Corp.* and *First Railroad & Banking Co. of Ga.* However, the reinsurance treaty in this case corresponds to the arrangement considered in *Economy Finance Corp.*

APPENDIX

IN THE UNITED STATES COURT OF CLAIMS

No. 109-68

(Decided October 22, 1975)

PENN SECURITY LIFE INSURANCE COMPANY

v.

THE UNITED STATES

John B. Jones, Jr., for plaintiff; *Owen T. Armstrong*, attorney of record. *Lowenhaupt, Chasnoff, Freeman, Holland & Mellitz, Robert A. Kagan, John T. Sapienza, Andrew W. Singer*, and *Covington & Burling*, of counsel.

Herbert Grossman, with whom was *Assistant Attorney General Scott P. Crampton*, for defendant. *Gilbert E. Andrews* and *Roger A. Schwartz*, of counsel.

Before COWEN, *Chief Judge*, DAVIS, NICHOLS, SKELTON, KASHIWA, KUNZIG, and BENNETT, *Judges*.

PER CURIAM:* Section 801(a) of the Internal

* This opinion incorporates the opinion of Trial Judge Lloyd Fletcher, with minor changes and some additions.

Revenue Code, as amended, defines a life insurance company in the following language:

> (a) Life Insurance Company Defined.—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—
>
> (1) its life insurance reserves (as defined in subsection (b)), plus
>
> (2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,
>
> comprise more than 50 percent of its total reserves (as defined in subsection (c)).[1]

In *Alinco Life Insurance Company* v. *United States*, 178 Ct. Cl. 813, 373 F. 2d 336 (1967), the court addressed its attention to the question of whether an insurance company specializing in the reinsuring of *credit life* insurance could qualify as

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[1] Section 801 goes on to provide:

* * * * *

"(c) *Total Reserves Defined.*—For purposes of subsection (a), the term 'total reserves' means—

(1) life insurance reserves.

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) all other insurance reserves required by law.

"The term 'total reserves' does not include deficiency reserves (within the meaning of subsection (b) (4))."

a life insurance company under Section 801, and held that it could, provided it met the 50 percent test. As might have been easily predicted, the question of life insurance company qualification is now back before the court with emphasis, however, on those provisions of Section 801 dealing, not with life insurance, but with health and accident insurance. In applying Section 801 to this case, we appreciate that the statute was *not* "written for ordinary folk * * *." It is addressed to technical specialists (*i.e.*, actuaries) and hence, its provisions "must be read by judges with the minds of the specialists." Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COL. L. REV. 527, 536 (1947).

On balance, we have concluded that plaintiff-taxpayer has the better of the argument and qualifies as a life insurance company so that it is entitled to recover. To explain why requires, first of all, a description of the taxpayer's method of conducting its insurance business during the years in issue, namely, the calendar years 1963, 1964, and 1965.

In those years, plaintiff's business consisted primarily of reinsuring risks written by three unrelated insurance companies under credit life, accident and health policies on the lives and health of debtors of plaintiff's parent, Aetna Finance Company (Aetna). Aetna was engaged in the business of making consumer loans through subsidiaries operating over 200 finance company offices in approximately 25 states.

In connection with such loan transactions, it was commonplace for Aetna's borrowers to apply for

and receive credit life insurance policies (or group insurance certificates), including health and accident benefits, from one of three insurance companies, namely, Old Republic Life Insurance Company (Old Republic), Pilot Life Insurance Company (Pilot), and National Fidelity Life Insurance Company (National Fidelity). Hereafter, these companies are frequently referred to as "the ceding companies," and plaintiff had separate disability reinsurance treaties in force with each of them during the years involved.

Under the life insurance provisions of these policies, the insurer was required to pay the creditor any outstanding balance of the debt in the event of the insured debtor's death. The health and accident provisions called for the insurer to pay debt installments falling due while the insured was totally disabled and unable to work. The terms of the policies (or group certificates) were coextensive with the contractual term of the related indebtness, usually two to three years.

Under its reinsurance treaties with the ceding companies, plaintiff agreed to reinsure 100 percent of the liability of each ceding company with respect to disability benefits included in credit life policies issued to Aetna and its borrowers. These treaties provided for payment of reinsurance premiums to plaintiff on a monthly earned premium basis; *i.e.*, a reinsurance premium was payable each month with respect to reinsurance coverage provided during the previous month based on a percentage of premiums "earned" on covered policies during that month.

All of the credit insurance policies issued by the ceding companies called for payment of insurance premiums (both a life insurance premium and, where applicable, a disability premium) at the inception of the policy term. When a disability premium is first received under such a policy, it is wholly "unearned" in the sense that the entire premium is attributable to the unexpired portion of the policy. As the term of the policy expires each month, a proportionate part of the premium becomes "earned"; *i.e.*, attributable to insurance protection provided during that month.

Thus, to use plaintiff's illustration, if a ceding company received a $360 disability premium on January 1, 1963, with respect to a policy providing insurance coverage for 36 months, one-thirty-sixth of this premium (or $10) would be considered "earned" during the month of January and each succeeding month. The "unearned" premium would be $350 at the end of January, $340 at the end of February, and so on. Under its disability reinsurance treaties, plaintiff was entitled to a monthly reinsurance premium equal to a percentage of the $10 "earned" premium for reinsurance coverage actually provided each month. The ceding companies retained all unearned premiums on policies covered under the disability reinsurance treaties and established an unearned premium reserve in the amount of such unearned premiums for the benefit of their policyholders in accordance with the applicable restrictions of state law and in satisfaction of the reserve require-

ments of the various states in which they did business.

Since plaintiff received no unearned premiums from the ceding companies, it was not required to establish an unearned premium reserve by the State of Missouri. No actuary or state regulatory authority required plaintiff to establish an unearned premium reserve under its disability reinsurance treaties with the ceding companies, since plaintiff never received premiums thereunder for insurance to be provided in the future or premiums which it might otherwise be required to refund.

Approximately two-thirds of the unearned premium reserves held by the ceding companies represented unearned "loading" charges made to cover profits and sales and office expenses. The remaining one-third of such unearned premium reserves represented unearned *net* premiums charged to policyholders to cover the expected cost of providing disability insurance benefits; this portion alone (known in the industry as the morbidity element) reflected the amount that the companies were actuarially required to hold in order to pay disability claims as they matured. Unearned loading charges are held as part of unearned premium reserves because the casualty insurance industry has traditionally determined its reserve requirements with regard to the full amount of premiums that would have to be refunded if all policies in force were simultaneously canceled instead of reserving only for the cost of carrying the insurance risk (the unearned *net* premiums) as in life insurance.

As insureds grow older, the mortality or morbidity costs increase and when an accident and health policy is written for a long term of years, the guaranteed level premium charged will not be sufficient to provide benefits after the insured reaches a specified age. In those instances, a reserve, in addition to the pro rata gross unearned premium reserve, is set up out of current premiums to provide for the excess of future benefits over future premiums. No such reserves were created by the three insurers with regard to the credit accident and health policies reinsured with taxpayer, presumably because such policies were relatively short-term.

In addition to its reinsurance treaties with the ceding companies during the years in issue, plaintiff also issued its own group annuity policy on December 22, 1965 (Group Annuity Contract No. 101) to the St. Louis Union Trust Company as trustee of Pension Fund No. 6 of the International Telephone Retirement Plan for Salaried Employees, which contract has remained outstanding and in effect to the present time. Plaintiff received securities valued at $5,929,057.24 for the purchase of single premium annuities under Group Annuity Contract No. 101 on or about December 22, 1965. Prior to this transaction, no group annuity or individual annuity contracts had been purchased by any trustee of any pension fund under the International Telephone Retirement Plan for Salaried Employees on the lives of the individuals covered under Group Annuity Contract No. 101.

Plaintiff maintained a reserve of $6,072,004 on December 31, 1965, with respect to its liabilities under Group Annuity Contract No. 101 on that date. Such reserve was computed on the basis of a recognized mortality table (1959 G.A.) and an assumed rate of interest (3½%), and was set aside to mature or liquidate future unaccrued claims arising under Group Annuity Contract No. 101.

On April 4, 1968, plaintiff filed a petition with this court seeking a refund of income taxes for the years in issue on the grounds, *inter alia*, that it was entitled to deduct accrued and unpaid losses under Section 809(d)(1) of the Code and to take such losses into account in determining the increase in its reserves for those years as provided in Section 809(d)(2) of the Code. On October 24, 1968, a notice of deficiency was mailed to plaintiff with respect to the years covered in plaintiff's petition. The deficiencies proposed therein were based upon the assertion that plaintiff did not qualify as a life insurance company during the years 1963, 1964, and 1965 under Section 801(a) of the Code, and upon that assertion, by an Amended Answer, defendant filed a counterclaim herein.

On February 14, 1969, after the time provided by statute for petitioning the Tax Court had expired but while plaintiff's tax liability for the years covered by the notice of deficiency was still before this court, the Commissioner of Internal Revenue assessed the amount of the asserted deficiencies in plaintiff's income tax, together with interest on such deficiencies, and demanded payment thereof. Plaintiff contested

the validity of this assessment, but paid such amounts under protest on March 5, 1969. On March 30, 1970, plaintiff filed its First Amended Petition with this court seeking recovery of the amounts claimed in its original petition as well as the amounts of the asserted deficiencies paid on March 5, 1969. In its Answer to plaintiff's First Amended Petition, defendant stated that "since the Plaintiff has paid the taxes for which the counterclaim was filed and amended its petition to include a claim for refund for these taxes, a counterclaim by the defendant is no longer necessary, nor required by law."

Plaintiff attacks the validity of the assessment described in the preceding paragraph. The argument is that, at a time when plaintiff had a refund suit pending in this court for the years 1963, 1964, and 1965, defendant determined additional deficiencies for those same years thus bringing into play the provisions of Section 7422(e) of the Internal Revenue Code. In pertinent part, that section reads as follows:

> (e) Stay of proceedings.—If the Secretary or his delegate prior to the hearing of a suit brought by a taxpayer in a district court or the Court of Claims for the recovery of any income tax, * * * mails to the taxpayer a notice that a deficiency has been determined in respect of the tax which is the subject matter of taxpayer's suit, the proceedings in taxpayer's suit shall be stayed during the period of time in which the taxpayer may file a petition with the Tax Court for a redetermination of the asserted deficiency, and for 60 days thereafter. If the taxpayer files a petition with

> the Tax Court, the district court or the Court of Claims, as the case may be, shall lose jurisdiction of taxpayer's suit to whatever extent jurisdiction is acquired by the Tax Court of the subject matter of taxpayer's suit for refund. If the taxpayer does not file a petition with the Tax Court for a redetermination of the asserted deficiency, the United States may counterclaim in the taxpayer's suit, * * * within the period of the stay of proceedings notwithstanding that the time for such pleading may have otherwise expired. The taxpayer shall have the burden of proof with respect to the issues raised by such counterclaim * * * of the United States except as to the issue of whether the taxpayer has been guilty of fraud with intent to evade tax.

Plaintiff asserts that the procedure prescribed in Section 7422(e) invalidates the assessment described above because the section must be read as calling exclusively for a counterclaim. While the argument is an ingenious one, we find it without merit.

First of all, it overlooks the permissive, as opposed to mandatory, wording of Section 7422(e) which merely states that the Government "may counterclaim in the taxpayer's suit." The effect of such language is explained in *Bar L Ranch, Inc.* v. *Phinney*, 400 F.2d 90, 92 (5th Cir. 1968) as follows:

> In Flora v. United States, 1958, 362 U.S. 145, 80 S.Ct. 630, 4 L. Ed.2d 623, the Supreme Court explained that when a taxpayer chooses to remain in the district court in a case similar to the instant case, "the Government may—but seemingly is not required to—bring a counter-

> claim; and if it does, the taxpayer has the burden of proof." This language indicates that the counterclaim is a permissive one, and that other methods may be used for the collection of the tax. Thus the Court assumed that any assessment of the tax would be valid since a separate collection suit would have to be based on a valid assessment. See also Florida v. United States, 8th Cir. 1960, 285 F.2d 596.

The Circuit Court then went on to hold that an assessment, in essence similar to the one disputed here, was valid.

Secondly, plaintiff apparently would ignore the limitations provisions contained in Section 6501 of the Code. That section requires the Government to assess "within 3 years after the return was filed * * *." By Section 6501(c)(4) that period may be extended by mutual consent of the taxpayer and the Government, a procedure presumably well known to the able and sophisticated tax counsel for this plaintiff. No effort is made to explain why this was not done in the present case.

However, lastly and in all events, the decision for plaintiff on the merits, as below, would seem to render this procedural point moot.

The Section 801 Issue

Turning to the merits, it is necessary at the outset to determine whether plaintiff, under Section 801 of the Internal Revenue Code, qualifies for taxation as a life insurance company. As was pointed out in *Alinco*, *supra* at 838, 373 F.2d at 350, the

qualification formula in Section 801 may be expressed in terms of the following fraction, the quotient of which must be more than 50 percent in order for an insurance company to qualify as a life insurance company:

Qualifying reserves (numerator)	÷	Total reserves (denominator)
1. Tabular reserves on life, annuity, and noncancellable accident and health policies		1. Tabular reserves on life, annuity, and noncancellable accident and health policies
2. Unearned premiums on noncancellable life, health, or accident policies not included in (1)		2. Unearned premiums not included in (1)
3. Unpaid losses on non cancellable life, health, or accident policies not included in (1)		3. Unpaid losses not included in (1)
		4. All other insurance reserves required by law.

If one goes no further than plaintiff's own books and records, it is clear from the figures set out in finding 14, *infra*, that plaintiff's quotient (or reserve test ratio, it is frequently called) exceeded 50 percent in each taxable year. Defendant does go further, however. Using a process somewhat reminiscent of a Section 482 allocation of income between related corporations, defendant would allocate or, to use its word, attribute to plaintiff the unearned premium reserves of the ceding companies established by them with respect to their disability policies reinsured by plaintiff. Defendant justifies this attribution upon the theory that reserves must follow the risk and, by increasing the denominator of the above fraction, the effect is to decrease plaintiff's reserve test ratio below 50 percent in each year.

Plaintiff, of course, objects vigorously to this attribution to it from unrelated companies of unearned premium reserves which it was not required to hold, had no right to hold, and did not in fact hold. It points out that, under its reinsurance treaties with the ceding companies, plaintiff neither received nor had any right to receive "unearned premiums" as that term is defined in Treas. Reg. Section 1.801-3 (e),[2] because those treaties provided that the monthly reinsurance premiums were payable only *after* they had been earned by plaintiff, not in advance. Plaintiff is correct in these contentions.

Presented with a credit reinsurance arrangement essentially identical to the present case, the U.S. District Court for the Southern District of Indiana held for the taxpayer. *Economy Finance Corp.* v. *United States*, 30 AFTR 2d 72-5446 (July 25, 1972), rev'd. 501 F.2d 466 (7th Cir. 1974), *cert. denied*, 420 U.S. 947 (1975). There, as here, the Government sought to disqualify from life insurance company status reinsurers by adding "unearned premiums" held by a ceding company to their "total reserves." Again like the present case, the reinsurance treaties provided for payment of the reinsurance of credit accident and health risks on a monthly earned premium basis. The District Court found that such "reinsurance on a month-to-month basis is not an uncommon or un-

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[2] The regulation states that the term "means those amounts which shall cover the cost of carrying the insurance risk *for the period for which the premiums have been paid in advance* * * *." (Emphasis supplied.)

accepted reinsurance arrangement" and in a comprehensive and well-reasoned opinion refused to attribute the ceding company's unearned premium reserves to the reinsurer. 30 AFTR 2d at 72-5451. In this respect, the court found the mode of premium payment conclusive, saying:

> * * * An unearned premium reserve is required to be established only with respect to that portion of the premium (or reinsurance premium) which has been received by the insurance company prior to the expiration of the period of coverage to which that premium relates. An insurance company is not required to establish an unearned premium reserve with respect to premiums or reinsurance premiums to be received in the future. Since under the terms of the accident and health Reinsurance Treaties reinsurance premiums were due from Standard Life to National Life and United Life only in the month succeeding the month for which the two reinsurers assumed the risk on the credit accident and health insurance policies issued by Standard Life, those reinsurance premiums were fully earned when received. It therefore would have been improper for National Life or United Life to establish any unearned premium reserve. Since National Life and United Life received only reinsurance premiums which represented payments for the assumption of insurance risks by those companies which had already expired by each reserve date, they were not required to set up unearned premium reserves. No state regulatory agency would have required National Life or United Life to set up unearned premium

> reserves with respect to the credit accident and health insurance which was issued by Standard Life and reinsured by National Life and United Life. Even without the cancellation provisions in the credit accident and health Reinsurance Treaties, it would not have been proper for National Life or United Life to set up unearned premium reserves since under the terms of those treaties they reinsured risks on a month-to-month basis. Since under the terms of the credit accident and health Reinsurance Treaties National Life or United Life were given the right to cancel the treaties upon giving 30 days' notice, in which event they would have been subject to only a limited amount of liability on policies then in force, an additional reason exists for their not being required to establish unearned premium reserves.

30 AFTR 2d at 72-5452.

We agree with the District Court's reasoning and result. The Seventh Circuit reversed the District Court but we cannot accept the rationale of the majority of the Court of Appeals. It should be noted, first, that the facts in *Economy Finance Corporation* differed from those in the present case in one important respect. Those taxpayers had agreements with the ceding company under which the latter was required to invest most of the unearned premium reserves in subordinated debentures of the parent of one of the taxpayers, and then to turn over the interest income received on those debentures as an "additional commission" to the insurance agency partnership composed of stockholders of one of the related taxpayers. *See* 501 F.2d at 470. Thus, the

Economy Finance taxpayers in effect received the proceeds of the unearned reserves even while in the hands of the ceding company. That arrangement was quite different from the one involved in the case at bar and could be understood as making that ceding company the agent of those taxpayers.

But the Court of Appeals, though it referred to that side-arrangement (*see* 501 F.2d at 471 n. 5, 477), did not center its decision thereon. Recognizing that the literal terms of § 801 favor the taxpayer (501 F.2d at 477), the Court of Appeals refused to apply the statute as written because, in its view, that interpretation failed to further Congress's purpose in giving special tax treatment to life insurance companies. That dominant objective the Seventh Circuit took to be the legislative desire to postpone half of the tax on investment income which accrues with respect to much life insurance and which cannot be accurately determined "until the life contract has been completely performed." *See* 501 F.2d at 474, 476-77. Since such investment income is not a factor for the health and accident policies involved in *Economy Finance* and here, the court considered that it would distort the Congressional purpose to allow those policies to be taken into account (without offsetting reserves) in determining whether the companies are entitled to "life insurance company" treatment.

We are far less certain than the Seventh Circuit that this was Congress's overriding aim. Section 801 is a technical provision, carefully worked out in some

detail over the years. As Circuit Judge Stevens pointed out in dissent in the *Economy Finance* case, Congress could have differentiated "life insurance companies" from others for tax purposes by selecting any of a number of measuring rods, but it chose a simple reserve-ratio test which has the advantage of being hinged to the requirements of state authorities as to the maintenance of adequate reserves, 501 F.2d at 483. The legislative history does not indicate that Congress zeroed in on policies connected with under writing income. Indeed, the reserve-ratio criterion was initially selected by Congress decades before the enactment of the current provisions for deferring part of the underwriting gain, at a time when Congress viewed premium receipts as not taxable because not true income but rather as analogous to permanent capital investment. *See Helvering* v. *Oregon Mutual Life Ins. Co.*, 311 U.S. 267, 268-69 (1940); *Alinco Life Ins. Co.* v. *United States*, *supra* at 831, 373 F.2d at 346. Moreover, Congress imposed statutory limits on the amount of deferrable underwriting income (*see* § 815(d)(4)), and there is no certainty that a company qualified as a "life insurance company" would be able to take full advantage of that privilege, perhaps not at all.

Still another indication, in our view, that Congress probably did not intend to restrict the concept of "life insurance company" to those firms having a predominance of policies yielding deferrable underwriting income is the Code's treatment of "modified coinsurance." In that situation the ceding com-

pany holds the reserves on reinsured risks, but also pays over the investment income from the reserve to the reinsurer. Congress has provided in § 820 that the reinsurer may, though it need not, take the ceding company's reserve into account but only if both parties consent to this treatment. *See also* Rev. Rul. 70-508, 1970-2 C.B. 136. As taxpayer points out, this would result in the anomaly, under the Seventh Circuit's opinion, that a reinsurer may successfully avoid attribution if it has the ceding company pay over gross investment income from the reserve, but must accept attribution when the ceding company not only holds the reserve but keeps the investment income. Defendant's response is that § 820 does not relate to qualification as a "life insurance company" but only to the determination of taxable-investment income and gain, once qualification has been established. This is true but does not destroy the point that it is doubtful that Congress gave special treatment to life insurance companies primarily because of their underwriting income.

In addition, the consequences of the general rule laid down by the Court of Appeals are uncertain and unclear. Judge Stevens thought the majority's standard might well exclude from coverage under § 801 such a common form of life insurance as term insurance. *See* 501 F.2d at 486 n.7. There may be other untoward gaps or disharmonies. We cannot tell because the consequences of departing from the text of § 801 are opaque.

In these circumstances, it seems to us preferable to accept the statute as written, leaving to Congress

the function of closing loopholes (if they exist) or restructuring the provision in greater detail. The section is technical and specific, directed to a complicated but very narrow segment of the law. If there be some anomalies under the statute as it stands, the Congress is in far better position to clarify its purpose and to harmonize § 801 with the other provisions of the insurance portion of the Code. Though there may be some results which can be questioned on economic or actuarial grounds, the literal words of the section do not produce absurd results, or results which one can say are clearly contrary to the legislative purpose. *Cf. United States* v. *Olympic Radio & Television Co.*, 349 U.S. 232, 236 (1955). We agree therefore with Circuit Judge Stevens, dissenting in *Economy Finance* (501 F.2d at 485): "* * * the government's conclusion that life insurance represents less than half of taxpayers' total insurance business rests on a non-statutory standard. Congress may have acted unwisely in giving preferential tax treatment to life insurance companies, and it may have been unwise to select a reserve-ratio test as the definition of a life insurance company for tax purposes. Nevertheless, we must, of course, apply the test which Congress has specified."

Defendant also urges that a different result is called for by a recent decision by the Fourth Circuit Court of Appeals in *Superior Life Insurance Company* v. *United States*, 462 F.2d 945 (4th Cir. 1972). In our view, defendant's reliance on that case is entirely misplaced. *Superior Life* did not involve rein-

surance. The unearned premiums there involved were collected and held by the taxpayer's parent company (a finance company, not an insurer) under a group insurance policy issued by the taxpayer. The parent acted merely as the taxpayer's agent and "in reality the fund in [the parent's] hands was subject to being used to pay taxpayer's obligations and for the benefit of taxpayer whenever taxpayer so desired." *See Superior Life Ins. Co.* v. *United States*, *supra*, at 950. None of the facts on which the decision in *Superior Life* turned—(1) the agency relationship between the holder of the premiums and the insurance company, (2) the free availability of the unearned premiums to the insurance company, and (3) identity of control between the parent-agent and subsidiary-insurance company—is present here. Since the taxpayer in *Superior Life* "constructively received" unearned premiums under long-accepted principles of tax law, the Fourth Circuit's decision is entirely consistent with the fact that the existence of unearned premium depends upon the mode of premium payment.

On this phase of the case, mention should be made of plaintiff's argument that defendant's "reserves follow the risk" rule has been recently rejected by this court in *Title Guarantee Co.* v. *United States*, 193 Ct. Cl. 1, 432 F.2d 1363 (1970). Defendant continues to urge, however, that the earlier decision of *Colonial Surety Co.* v. *United States*, 147 Ct. Cl. 643, 178 F. Supp. 600 (1959), established a "reserves follow the risk" rule for tax purposes. But in

Title Guarantee the court rejected that argument and distinguished the *Colonial Surety* case as follows:

> * * * The plaintiff [in the *Colonial Surety* case] sought to deduct *unearned commissions and not unearned premiums.* * * *
>
> The government argues that the portion of the trust fund attributable to the parts of the policies reinsured should not be considered as unearned premiums * * * for the reason that the taxpayer is no longer carrying the risk on the parts reinsured. *We cannot accept this theory.* Even though plaintiff has obtained reinsurance, it is still liable to the policyholder in case of loss and is, therefore, still carrying the risk despite the reinsurance.

Title Guarantee Co. v. *United States, supra,* 193 Ct. Cl. at 25, 432 F.2d at 1376. (emphasis added).

Finally, at a later stage in this litigation the court itself injected an issue which had not been presented to the trial judge or to the three-judge panel of the court which first heard the argument. As a result of the decision by a different trial judge in *Consumer Life Ins. Co.* v. *United States,* No. 463-70, the court ordered the parties to brief and argue the question of whether *state law* required the taxpayer to establish an insurance reserve for the unearned premiums involved here (if so the case would be governed by Section 801(c)(3), *supra* note 1, and the taxpayer would lose). The case was then ordered to be heard en banc.[3] It has since been held awaiting

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[3] This was done before the three-judge panel had rendered its decision.

the decision in *Consumer Life Ins. Co.* which was argued somewhat later. That case is also being decided today, and on the new issue of the requirements of state law we dispose of this case on the reasoning of the court's opinion in *Consumer Life*—Missouri law did not require taxpayer to establish reserves for the premiums involved here.[4]

From all the foregoing, it is concluded that defendant's attempt to attribute to plaintiff the unearned premiums reserves actually held by the ceding companies is incorrect. Accordingly, plaintiff's reserve test ratio for 1963 was 68.50 percent, for 1964 was 54.48 percent, and for 1965 was 85.76 percent. *See* finding 14, *infra.* Therefore, plaintiff qualified in those years as a life insurance company under Section 801, and it is unnecessary to reach alternative arguments made by counsel for the parties.

Plaintiff's Group Annuity Policy No. 101

On December 22, 1965, plaintiff issued its own group annuity policy No. 101 to the St. Louis Union Trust Co. as trustee of Pension Fund No. 6 of the International Telephone Retirement Plan for Salaried Employees. At December 31, 1965, plaintiffs reserve

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[4] *See* Findings of Fact 19, 20, 21, 22, 28, and especially 29 *infra.* Defendant relies mainly on *Vernon's Annotated Missouri Statutes* § 376.410(1), (3), and (4), but the text of those provisions fully harmonizes with the interpretation of Missouri law spelled out in our findings and followed by the Missouri insurance administrators, *i.e.*, that Missouri law did not during the years in question require this taxpayer to set up the reserves in question.

held with respect to annuities purchased under this policy was $6,072,004. In computing the amount of its reserves under Section 801(b)(5) which requires life insurance companies to use the mean of reserves held at the beginning and end of the year, plaintiff included $3,036,002 (0+$6,072,004÷2) with respect to this annuity policy.

Defendant recomputed the annuity reserves under Section 806(a) by adjusting them on a daily basis. This adjustment was accomplished by applying a fraction to the reserve, the numerator of which was the number of days during the year in which the reserve was held and the denominator of which was the number of days in the year, and the result was to reduce plaintiff's year-end reserve to $502,156. Claiming this adjustment to be entirely erroneous, plaintiff asserts that neither the language nor the purpose of Section 806(a) covers reserves held under a newly issued policy by the original insurer, as was the case of Annuity Policy No. 101. Section 806(a) reads:

> For purposes of this part, if, during the taxable year, there is a change in life insurance reserves attributable to the transfer between the taxpayer and another person of liabilities under contracts taken into account in computing such reserves, then, under regulations prescribed by the Secretary or his delegate, the means of such reserves, and the mean of the assets, shall be approximately adjusted, on a daily basis, to reflect the amounts involved in such transfer. This subsection shall not apply to reinsurance ceded to the taxpayer or to another person.

Plaintiff argues that this section was designed by Congress exclusively to deal with acquisitions of reserves by one insurance company from another insurance company in those cases (commonly referred to as "assumption reinsurance") where the acquiring company becomes solely liable in place of the transferor company on the insurance contracts under which the acquired reserves are held. Clearly this did not occur in the present case, and the argument is that, therefore, Section 806(a) cannot apply but instead the more general averaging provisions of Section 801(b)(5) govern.

From the admittedly rather sparse legislative history, plaintiff would seem to be correct in this contention. For example, the following appears in S. Rep. No. 291, 86th Cong., 1st Sess. 51 (1959) (1959-2 C.B. 807):

> * * * Subsection (a) of your committee's new section 806 relates to situations where there is a change in life insurance reserves (either increases or decreases) attributable to the transfer of liabilities under contracts taken into account in computing such reserves. This occurs, for example, when life insurance company I purchases all or a part of the business of life insurance company X under an arrangement (sometimes referred to as "assumption reinsurance") whereby company I becomes solely liable to the policy holders. Both I and X will have to make the adjustments provided by subsection (a).

The illustration which follows the above excerpt, as well as the examples given in Treas. Reg. Section

1.806-3(a), all deal with transactions and transfers between insurance companies.

Defendant agrees that the examples cited all illustrate transfers between insurance companies but counters with the observation that the regulations and Committee Reports do not specifically limit the section in the manner contended for by plaint. and points to the language of the statute which covers transfers "between the taxpayer and *another person.*" (emphasis supplied.) If Congress intended to limit the applicability of Section 806(a) to transfers between insurance companies, defendant suggests it would have used the phrase "insurance company" instead of the word "person." This is an appealing argument, but, in our view, it is clearly offset by plaintiff's rational rejoinder that Congress used the term "person" with a view to reaching all acquisitions of reserves under *pre-existing insurance* contracts, including those in which the transferor may not qualify as an insurance company for *tax purposes,* and not to require a special adjustment of reserves when a *new* policy is issued to the trustee of a pension plan, such as St. Louis Union Trust Co.

Plaintiff also seems on sound ground in contending that the inapplicability of Section 806(a) to the issuance of a new insurance contract is manifest in defendant's inability to show here any "liabilities" on the part of the transferor, any "transfer" of such "liabilities," and any reserves computed on the basis of the transferor's "liabilities." It is not disputed that under the IT&T pension plan the employer had

no liability for the payment of benefits nor that under the trust agreement the trustee was not liable for losses other than those resulting from its own neglect.

Nonetheless, says defendant, their fiduciary duties and obligations under the plan constituted "essentially an insurance function." However, as plaintiff observes, this misconceives the nature of the fiduciary relationship. It is hornbook law that a trustee is not an insurer but at most has the responsibility prudently to manage the trust funds in accordance with the purpose set forth in the trust instrument. *See* 3 SCOTT on TRUSTS § 204 (3d ed. 1967).

Finally, it can hardly be disputed that the annuity reserves in question were established as a result of liabilities incurred by plaintiff under its annuity policy No. 101 and were not attributable to "liabilities" assumed by plaintiff under the pension plan or the trust agreement. Hence, Section 806(a) does not apply.

The Unpaid Losses Deduction Issue

It is not disputed that in computing its "gain from operations" as defined in Section 809(b), plaintiff was entitled to a deduction under Section 809(d)(1) for accrued and unpaid losses of $120,596 in 1963, $55,605 in 1964, and $30,000 in 1965. The present problem arises because plaintiff asks to deduct them again under Section 809(d)(2) which allows a deduction for an increase in certain reserves, including the reserve for unpaid losses. If this were per-

mitted, the Government contends that the same item would be deducted twice in violation of Section 818 (f) which reads:

> (f) *Denial of double deductions.*—Nothing in this part shall permit the same item to be deducted more than once under subpart B and once under subpart C.

The Government also points to Treas. Reg. Section 1.809-5(b) which expressly bars the double deduction of unpaid losses and an increase in unpaid loss reserves in the following language:

> (b) *Denial of double deduction.* Nothing in section 809(d) shall permit the same item to be deducted more than once in determining gain or loss from operations. For example, if an item is allowed as a deduction for the taxable year by reason of its being a loss incurred within such taxable year (whether or not ascertained) under section 809(d)(1), such item, or any portion thereof, shall not also be allowed as a deduction for such taxable year under section 809(d)(2).

There can simply be no doubt that the example given in the above regulation specifically proscribes the 809(d)(2) deduction here claimed by plaintiff. Therefore, to hold for plaintiff would necessarily require a determination that the regulation is invalid, and such a determination is not permissible in our view.

Plaintiff has made no showing that the departmental construction exemplified in this regulation is so unreasonable as to require a holding of invalidity,

and long ago the Supreme Court had the following to say in *Boske* v. *Comingore*, 177 U.S. 459 at 470 (1900):

> Those who insist that * * * a regulation is invalid must make its invalidity so manifest that the court has no choice except to hold that the Secretary has exceeded his authority and employed means that are not at all appropriate to the end specified in the act of Congress.

Plaintiff's heavy reliance on *Title Guarantee, supra,* is misplaced, for there the court was not confronted with the necessity of holding a regulation invalid. Hence, as to this issue it is our view that the Government's position is correct.

Since, however, plaintiff should prevail on other remaining issues, as discussed above, it is entitled to recover with the amount thereof to be determined in further proceedings under Rule 131(c).

NICHOLS, *Judge*, dissenting:

Upon a careful reading of *Economy Finance Corp.* v. *United States*, 501 F. 2d 466 (7th Cir. 1974), *cert. denied*, 420 U.S. 947 (1975), I find it applies the text in IRC § 801(a), defining a Life Insurance Company in a sound and persuasive fashion. To avoid needless expansion of these remarks, I incorporate herein the analysis of the panel majority by reference so far as pertinent here. Were they less convincing than they are—unless plainly wrong

—our respect for *stare decisis* and our dislike for going into conflict with another court should have carried the day. The objectionable consequences of conflicting lines of decisions in Federal tax cases are fully set forth in the *Preliminary Report of the Commission on Revision of the Federal Court Appellate System*, App. IV. This deals with the "Relitigation Policy" attributed to defendant, but relitigation by diverse taxpayers pursuing a common scheme or plan of tax avoidance is just as objectionable.

Defendant, with the authority of the Seventh Circuit behind it, would "impute" to plaintiff reserves under H & A policies it has arranged to have ostensibly carried for it by others, though in reality it bears the risk of loss itself. When such reserves are so "imputed" the plaintiff fails to pass the 50% test and is not entitled to the special advantages enjoyed by life insurance companies. As the Seventh Circuit shows, non-imputation completely frustrates the purpose Congress has in mind in prescribing the test. The contrary view is simply another instance of stating: "we see what you mean, Congress, but you said it wrong." To a simple, uncomplicated mind, the imputation is fully justified by the ancient maxim: "*Qui facit per alium, facit per se.*" Plaintiff maintains the reserves for purposes of the 801 (a) test, though for no other purposes, because it has arranged, itself or through its affiliates, and using the economic leverage they jointly possess, to have these reserves available to satisfy the right the H &

A policy holders possess to have their risks covered by legally acceptable reserves.

FINDINGS OF FACT

The court, having considered the evidence, the decision and findings of Trial Judge Lloyd Fletcher, and the briefs and arguments of counsel, makes findings of fact as follows:

General Background

1. Plaintiff was incorporated on August 8, 1955, under the statutes of the State of Missouri applicable to the organization of life insurance companies. It is empowered by its Articles of Incorporation and authorized by the insurance authorities of the State of Missouri to engage in the business of issuing contracts insuring or reinsuring against death or disability, and has carried on such business exclusively.

2. Plaintiff is a wholly owned subsidiary of ITT Aetna Corporation, a second tier subsidiary of International Telephone and Telegraph Corporation (IT&T). Prior to August 31, 1964, plaintiff's capital stock was owned by the Aetna Finance Company. On that date, Aetna Finance Company sold all of its assets (including plaintiff's stock) to IT&T, which subsequently transferred those assets to ITT Aetna Corporation as a contribution to capital. (References made hereafter to "Aetna" refer either to Aetna Finance Company and its subsidiaries (other

than plaintiff) or ITT Aetna Corporation and its subsidiaries (other than plaintiff) as appropriate.) Aetna has at all relevant times been engaged in the business of making consumer loans through subsidiaries which, during the years in issue, operated over 200 finance company offices in approximately 25 states.

3. Plaintiff was originally incorporated under the name American Universal Life Insurance Company, and operated under this name during the years in issue. Its name was changed to ITT Life Insurance Company in 1966, to ITT Hamilton Life Insurance Company in 1967, and finally to Penn Security Life Insurance Company on December 29, 1972.

4. Plaintiff's principal business, until approximately 1966, consisted of reinsuring death and disability risks underwritten by unrelated insurance companies in respect of credit life insurance policies issued by those companies to Aetna and its loan customers. By 1967, plaintiff's volume of business increased to the point at which it became more profitable for it to write its own credit insurance policies than to reinsure other companies. Plaintiff today writes a complete portfolio of the standard forms of ordinary and term insurance contracts including individual and group life, accident and health, and surgical coverage, as well as credit insurance for borrowers and installment purchasers.

5. Credit life insurance is usually sold as part of another and more prominent transaction, namely, a loan of money or an installment sale of tangible

personal property. Its primary function is to provide a sure, quick, and uncomplicated means for liquidating the balance due on the loan or installment sale in the event of the death of the borrower or purchaser and, where health and accident coverage is combined with credit life insurance to also pay the borrower's monthly installment while he is unable to work. It is generally written for a term which is coextensive with the contractual term of the related indebtedness. Occasionally a company may write a credit insurance policy with a term of as long as 5 years, but the average in the industry is two to three years in most instances.

6. Credit insurance may be written under an individual insurance policy issued directly to the insured debtor, or under a group policy, in which case the beneficiary-creditor is the policy holder and the individual insured debtor simply receives a certificate of insurance as evidence of coverage under the group policy. In either case, the creditor is the primary beneficiary to the extent of the unpaid balance of the indebtedness at the time of the insured debtor's death or disability.

7. Most of the credit insurance policies issued to Aetna and its loan customers during the years in issue (1963, 1964, and 1965) were written by three insurance companies: Old Republic Life Insurance Company of Chicago, Illinois (Old Republic), Pilot Life Insurance Company of Greensboro, North Carolina (Pilot), and National Fidelity Life Insurance Company of Kansas City, Missouri (National Fi-

delity). (Old Republic, Pilot, and National Fidelity are hereinafter sometimes referred to as "the ceding companies"). To a much lesser extent, credit insurance policies were also issued to Aetna and its loan customers by Insurance City Life Company (Insurance City) and the American Bankers Life Assurance Company of Florida (American Bankers). Plaintiff had reinsurance agreements or "treaties" in force with each of the above companies during the years in issue.

8. All credit life insurance policies and certificates issued by the ceding companies to Aetna and its loan customers provided for the payment of the entire premium (including the disability premium where accident and health coverage was included in the policy or certificate) at the inception of the policy term. When a disability premium under a single premium policy is first paid by the insured, it is wholly "unearned," in the sense that the entire premium is attributable to the unexpired portion of the policy. As the term of the policy expires with the passage of time, a proportionate part of the premium becomes "earned;" *i.e.*, attributable to insurance protection provided during the expired portion of the policy.

9. Unlike insurance such as fire, public liability, and similar types of casualty insurance, credit life insurance contracts, including those reinsured by plaintiff (both with and without disability benefits), cannot be canceled by the insurer during the term for which they are written. However, the policies

issued by the ceding companies to Aetna and its loan customers typically provided that insurance thereunder would terminate prior to the end of the term of the policy (usually, the maturity date of the indebtedness): (1) by renewal, refinancing, or repossession of the collateral for the indebtedness in connection with which the insurance was issued, (2) upon discharge of such indebtedness by payments by or on behalf of the debtor to the creditor, (3) by the indebtedness or any portion thereof being charged off or being required to be charged off by the laws applicable to the creditor, and (4) by cancellation of the insurance by the insured debtor. Under any of these circumstances, the policy typically provided for a refund of the unearned portion of premiums paid by the insured debtor in accordance with a prescribed formula, usually the Rule of 78.

10. Under the Rule of 78 or "sum-of-the-digits" method, the unearned premium is computed by applying changing fractions each year (or month, if unearned premiums are determined monthly) to the premium paid by the insured. The numerator of the fraction changes each year (or month) to a number which corresponds to the sum of the digits of the remaining unexpired term (years or months) of the policy, and the denominator, which remains constant, is the sum of all the years' (or months') digits corresponding to the entire term of insurance coverage. For example, if an insured debtor paid a $300 premium for disability benefits at the inception of

a three-year single premium policy, he would be entitled to a refund under the Rule of 78 of $300 $\left(\frac{3+2+1}{3+2+1}X\$300\right)$ if the policy was terminated at the beginning of the first year, $150 $\left(\frac{2+1}{3+2+1}X\$300\right)$ if the policy was terminated at the beginning of the second year, and $50 $\left(\frac{1}{3+2+1}X\$300\right)$ if the policy was terminated at the beginning of the third year.

11. The casualty insurance industry has historically viewed the unearned premium reserve as that portion of premiums paid by policyholders that is attributable to the unexpired terms of outstanding policies and that would have to be refunded to policyholders if all policies in force were to be canceled as of the statement date. The concept of an unearned premium serves several functions with respect to accident and health insurance. Primarily, the unearned net premium represents funds that must be held to provide the cost of the insurance risk which has not yet expired porportionate to the period for which premiums have been paid in advance. Unearned loading charges, which are obtained by subtracting the unearned net premium from the total unearned gross premium reserve, constitute a solvency reserve for the payment of refunds and future expenses. Unearned premium reserves maintained by the ceding companies on credit accident and health insurance covering debtors of Aetna were computed under the Rule of 78 method,

the same method normally used in determining the required refund to policy holders in the event of a premature termination of a policy. One result of including unearned loading charges in the unearned gross premium reserve is a heavy charge to surplus which sometimes prevents the ambitious or over-rapid expansion of a company that might well result in its ultimate insolvency. Another result is that it imposes in an indirect manner additional capital requirements on companies having larger amounts of business in force.

12. Generally speaking, where insurance coverage is provided, the premium payable by the insured under the policy is due and payable at the outset of coverage. Whether this requirement obtains as between a ceding company and its reinsurer company depends on the provisions of the reinsurance treaty between them.

13. More than half of the dollar value of benefits reinsured by plaintiff during the years in issue under its treaties with the above companies were life insurance benefits. Some of the policies covered under plaintiff's reinsurance treaties were credit life insurance policies providing only death benefits. The remaining policies were credit life insurance policies combined with accident and health coverage, but the latter coverage never exceeded the amount of life insurance benefits provided under the policy (normally, the amount of the loan). With but one exception, none of the covered policies provided only credit accident and health insurance.

The Life Insurance Company Issue

14. For each of its taxable years ended December 31, 1963, 1964, and 1965, the mean of plaintiff's life insurance reserves at the beginning and end of each year comprised more than 50 percent of the mean of its total reserves at the beginning and end of each year, as such reserves were reported on the annual statements submitted by plaintiff to the Missouri Division of Insurance and on the income tax returns filed by plaintiff for those years. The ratio of plaintiff's life insurance reserves to its total reserves under plaintiff's view of the case and as computed on its income tax returns for 1963, 1964, and 1965 were as follows:

	Jan. 1, 1963	Dec. 31, 1963	Mean
Life Insurance Reserves	$556,923.00	$733,027.00	$644,975.00
Total Reserves	790,108.00	1,092,918.49	941,513.28
Reserve Test Ratio (1÷2)			68.50%
	Jan. 1, 1964	Dec. 31, 1964	Mean
Life Insurance Reserves	733,027.00	806,698.00	769,862.50
Total Reserves	1,092,918.49	1,733,125.97	1,413,022.23
Reserve Test Ratio (1÷2)			54.48%
	Jan. 1, 1965	Dec. 31, 1965	Mean
Life Insurance Reserves	806,698.00	7,037,233.00	3,921,965.50
Total Reserves	1,733,125.97	7,413,108.58	4,573,117.28
Reserve Test Ratio (1÷2)			85.76%

15. The determination of the Commissioner of Internal Revenue that plaintiff was not a "life insurance company" as defined in Section 801 of the Code in 1963, 1964, and 1965 was based upon his inclusion in plaintiff's "total reserves" of unearned gross premiums actually held by the ceding companies (*i.e.* Old Repub-

lic, Pilot, and National Fidelity) in respect of disability benefits under credit life insurance policies (combined with health and accident insurance) issued by those companies to Aetna and its loan customers. The amounts of "unearned premiums" added by the Commissioner of Internal Revenue to plaintiff's "total reserves" as of December 31, 1962, 1963, 1964, and 1965 were as follows:

Unearned Premiums Attributed to Plaintiff

From	Dec. 31, 1962	Dec. 31, 1963	Dec. 31, 1964	Dec. 31, 1965
Old Republic	$183,342	$147,375	$145,833	$191,416
Pilot	728,821	782,726	724,445	829,480
National Fidelity	413,973	495,288	570,083	773,670
Total	1,326,635	1,425,389	1,440,351	1,794,566
	[*sic* 1,326,136]			

The Government now concedes that unearned premiums under the Old Republic Disability Reinsurance Treaty are not attributable to taxpayers for purposes of qualification as a life insurance company.

16. The unearned premiums attributed to plaintiff by the Commissioner of Internal Revenue as of December 31, 1962, 1963, 1964, and 1965 were actually held by the ceding companies on those dates and were included in the unearned premium reserves shown on the annual statements which they submitted to the insurance authorities of the various states in which they did business. In recognition of their continuing obligations to their policyholders, the ceding companies were required, both from an actuarial standpoint and under state law, to establish such unearned premium reserves while they actually held the unearned premiums in order to have funds

available to pay claims and refunds to their policyholders and to reflect the fact that they had received premiums from policyholders for insurance protection to be provided after the statement date. The annual statements of those companies, in which the unearned premiums which the Commissioner of Internal Revenue now seeks to include in plaintiff's reserves were shown as unearned premiums of the ceding companies, were accepted by the insurance authorities in all the states in which the ceding companies did business.

The ceding companies maintained the unearned premiums attributed to plaintiff along with their other reserve funds in accordance with the applicable restrictions of state law, and they received the proceeds from their investments of such funds (interest, dividends, etc.) as their own income. Plaintiff did not obtain or use the unearned premiums reflected in the annual statements of the ceding companies, nor were such unearned premiums credited, set apart or made available to plaintiff. None of the ceding companies was owned or controlled, directly or indirectly, by plaintiff, Aetna, or IT&T.

17. The health and accident portion of the combined policies or certificates issued in connection with group policies were entirely separate insurance contracts which set forth a separate health and accident premium. However, it has been stipulated that credit accident and health insurance was never in fact sold without credit life insurance coverage and, except in one state, the two coverages were never sold as sepa-

rate contracts. The life insurance reserves maintained by taxpayer on the life coverage were calculated without regard to any health and accident coverage written in combination therewith; conversely, the ceding companies ignored any combined life insurance coverage when they calculated and set up unearned premium reserves on the health and accident coverage.

18. Plaintiff had separate reinsurance treaties covering life insurance risks and disability insurance risks with each of the ceding companies during the years in issue. Under the disability reinsurance treaties, plaintiff agreed to reinsure 100 percent of the liability of each ceding company with respect to disability benefits included in credit life insurance policies issued to Aetna and its loan customers. The treaties provided for payment of a monthly reinsurance premium equal of 98 percent (89 percent under the Old Republic treaty) of the premiums earned with respect to credit accident and health insurance in force during the previous month. The following excerpts from the Pilot treaty are typical:

Article I.

> * * * Pilot Life agrees to reinsure with [Taxpayer] one hundred per cent (100%) of the total of all Credit Accident and Health issued by Pilot Life covering the debtors of Aetna Finance Company. * * *, and [Taxpayer] agrees to accept such reinsurance automatically.

Article II.

> 1. The liability of [Taxpayer] on all reinsurances shall begin simultaneously with that

of Pilot Life and in no event shall the reinsurance of [Taxpayer] be in force and binding unless the policy issued by Pilot Life is in force.

2. In all reinsurances the liability of [Taxpayer] shall cease when the liability of Pilot Life ceases.

* * * *

Article III.

1. Reinsurance payments to [Taxpayer] shall be made on or before the twenty-fifth of each calendar month, on a monthly term basis, based on all accident and health insurance in force during the previous month on policies reinsured with [Taxpayer].

2. The premium payable in any month shall be ninety-eight per cent (98%) of the earned premiums the previous month for all accident and health policies reinsured hereunder. Earned premiums for any month on such policies are all premiums written during such month, less returned premiums on such policies during such month, plus unearned premium reserves on such policies at the beginning of the month, and less the unearned premium reserves on such policies at the end of such month.

3. From the reinsurance premium due [Taxpayer] shall be deducted and withheld by Pilot Life:

A. The following expenses which are assumed by [Taxpayer]:

(1) All premium, occupational and privilege taxes applicable to the insurance.

(2) The cost of policy forms.

(3) Any special claim expense incurred by Pilot Life in accordance with Section 3 of Article IV hereof, and

(4) Any commissions paid to or retained by agents for writing the insurance; and

B. The total of all claims paid under reinsured policies during the period for which the premium is due.

4. If, at the time established for making any premium remittance, the total of the deductions listed in the preceding Section of this Article exceeds ninety-eight per cent (98%) of the earned premium for the period covered, [Taxpayer] shall pay to Pilot Life the amount of such excess upon receipt of a statement of the amount of such excess.

5. If this agreement is terminated as to new insurance, Pilot Life shall nevertheless be liable to [Taxpayer] for payment of monthly reinsurance premiums until all premiums on policies reinsured with [Taxpayer] prior to the termination have been earned, and [Taxpayer] shall nevertheless be liable to Pilot Life for payment of all claims arising out of policies reinsured with [Taxpayer] prior to the termination. After all reinsurance premiums have been paid, [Taxpayer] shall pay Pilot Life the amount of any claims on such reinsured policies, which claims were paid by Pilot Life and not deducted from reinsurance premiums, upon receipt of a statement of the amount of any such claims.

Article IV.

1. [Taxpayer] shall be liable to Pilot Life for the benefits covered by reinsurance hereunder to the same extent as Pilot Life is liable to the persons insured for such benefits and all reinsurance shall be subject to the terms and con-

ditions of the policy under which Pilot Life is liable.

2. Whenever a claim is made under a policy that Pilot Life reinsured under this agreement, it shall be considered by [Taxpayer] to be a claim for the full amount of reinsurance on such policy and [Taxpayer] shall abide by the settlement made by Pilot Life and shall pay the full amount of reinsurance.

3. Any suit or claim may be tested or compromised on the part of Pilot Life and in case of reduction of the claim made upon Pilot Life, the claim made upon [Taxpayer] shall be reduced accordingly. Any special expense incurred by Pilot Life in defending or investigating any claim shall be borne by [Taxpayer].

19. Plaintiff's disability reinsurance treaties with the ceding companies fell into the category of "reinsurance ceded"; *i.e.*, they were solely contracts of insurance between two insurance companies (the "ceding company" and the "reinsurer"), and did not create any contractual obligation running from the reinsurer (plaintiff) to the policyholders of the ceding companies. Such reinsurance did not relieve the ceding companies of contractual liabilities to their policyholders, e.g., the obligation to pay benefits and to refund unearned premiums in the event of cancellation or other termination of a policy before the expiration of its full term. Consequently, the mere fact that the ceding companies obtained reinsurance from plaintiff under these treaties did not affect their responsibility, under state law or under actuarial principles, to set up an unearned premium reserve to

reflect the unearned premiums actually held by those companies or policies covered by reinsurance treaties with plaintiff. Ceding companies, however, may obtain a credit on their annual statement forms for unearned premium reserves actually transferred to a reinsurer since, as explained by plaintiff's expert, the liability for an unearned premium reserve "depends on whether you've got the money or not * * *."

20. An unearned premium reserve measures an insurance company's reserve requirements by looking to premiums already paid by policyholders and then determining the portion of such premiums that represent payment for insurance to be provided after the statement date. Plaintiff was not required to establish an unearned premium reserve with respect to its reinsurance of the ceding companies because, as of each statement date, no portion of the reinsurance premiums received and held by plaintiff represented payment for insurance to be provided after the statement date; *i.e.*, all such reinsurance premiums were fully earned.

21. Life insurance reserves may be measured prospectively as the difference between the present value of future claims expected to be paid and the present value of premiums to be received. Even if this prospective test had been applied to plaintiff's disability reinsurance treaties with the ceding companies, under any reasonable assumption as to future claims, the present value of reinsurance premiums to be received under such treaties exceeded the present value of probable claims. Thus, measured either retrospectively or prospectively, plaintiff did

not have any reserve obligation under its treaties with the ceding companies.

22. Plaintiff had no contingent obligation to refund reinsurance premiums received from the ceding companies since it received such premiums only after they had been fully earned. Nor did plaintiff have any obligation to refund premiums paid by policyholders of the ceding companies in the event of cancellation or other premature termination of policies issued by the ceding companies. Consequently, there was no need for plaintiff to establish an unearned premium reserve for the purpose of maintaining a fund available for the refund of premiums.

23. Plaintiff also had a reinsurance treaty in force during the years in issue with Insurance City, which treaty covered both death and disability risks under credit life insurance policies issued by Insurance City to Aetna and its loan customers in the State of Rhode Island. All of the credit life insurance policies issued by Insurance City to Aetna and its loan customers (including those with disability benefits) provided for the payment of single premiums at the inception of the policy term on both life and accident and health coverages. Under its reinsurance treaty with Insurance City, plaintiff was entitled to receive the full disability premium collected by Insurance City for the entire policy term on policies covered under the treaty, less 10 percent of such premiums retained by Insurance City, in the month following receipt by Insurance City. Such reinsurance premiums were paid for reinsurance for the entire term

of policies issued by Insurance City to Aetna and its loan customers during that month, and not merely for reinsurance actually provided by plaintiff during such month. Therefore, plaintiff maintained unearned premium reserves with respect to that portion of premiums received from Insurance City which represented payment for reinsurance to be provided in the future.

24. The insurance business is regulated by the states. For example, the state insurance departments supervise policy forms, agency relationships, investments, accounting practices, reserves, and the general financial responsibility of insurance companies. State law and/or regulations direct insurance companies to set up reserves that are designed to preserve the solvency of those companies for the protection of policyholders.

25. For each of the years 1962, 1963, 1964, and 1965 plaintiff filed an annual statement with the Missouri Division of Insurance on the form prescribed by the National Association of Insurance Commissioners for life and accident and health companies. The annual statement is a record of the income and disbursements of an insurance company during the year on an accrual basis, as well as a balance sheet which reflects the solvency of the reporting insurance company at the end of the accounting period. The calendar year is the prescribed accounting period of all life insurance companies, including plaintiff.

26. Plaintiff's annual statements for the years

1962, 1963, 1964, and 1965 did not reflect any unearned premium reserves with respect to policies issued by Old Republic, Pilot, and National Fidelity, or with respect to plaintiff's reinsurance treaties with those companies. The only unearned premium reserves reflected on plaintiff's annual statements for the above years were unearned premium reserves relating to plaintiff's reinsurance treaty with Insurance City.

27. State insurance authorities monitor the adequacy of the reserves held by insurance companies within their jurisdictions by reviewing the annual statements submitted by those companies and by conducting a comprehensive audit at least once every three or four years. The examination includes a verification and evaluation of assets, the establishment of liabilities, and a general review of other records and procedures including the contracts and policies in force at the valuation date. If an insurance company did not properly report its liabilities as of the valuation date under examination, the examiners would recompute such liabilities in accordance with actuarial standards and governing state law and regulations.

28. Plaintiff was audited by the Missouri Division of Insurance in 1965 for the period from September 30, 1961, through December 31, 1964. Plaintiff was also audited in 1969 with respect to the period from January 1, 1965, through December 31, 1968, by the Missouri Division of Insurance with participation by examiners from the States of Mary-

land, Wyoming, and California. There was attached to the report of examination for the period September 30, 1961, through December 31, 1964, a statement from the consulting actuaries of plaintiff as follows:

> As Consulting Actuaries who aided in the preparation of the December 31, 1964 Financial Statement of American Universal Life Insurance Company, [now ITT Hamilton] we affirm that we determined the policy reserves listed below, and that the amounts thereof were computed in accordance with the terms of the outstanding policies and the Insurance Code of the State of Missouri, and that, based upon the records of the Company furnished to us, they are a true statement of the reserve liabilities of the Company as of December 31, 1964.
>
> 1. Aggregate Reserve for Life Policies $806,698.00
>
> 2. Aggregate Reserve for A. & H. Policies 59,673.48

29. The Missouri Division of Insurance did not require plaintiff to establish unearned premium reserves with respect to premiums received by the ceding companies for disability benefits provided by those companies under policies issued to Aetna and its loan customers or with respect to reinsurance premiums received by plaintiff under its disability reinsurance treaties with such companies. According to plaintiff's expert witness, no state regulatory authority would impose an unearned premium reserve requirement on an insurance company where, as

under plaintiff's disability reinsurance treaties with the ceding companies, such company did not receive premiums for insurance to be provided in the future.

30. The premium charge for a life insurance contract is computed so as to cover all the contingencies the insurance company is likely to meet, and these contingencies are generally grouped into three elements, namely, mortality, interest, and "loading" (*i.e.*, profit and expenses). Mortality refers to that part of the premium which provides for the occurrence of the risk insured against while the second element takes into account the assumed interest to be earned by the company. The third element primarily covers profit and the cost incident to management of the company, such as salaries, rents, commissions, taxes, and other costs of doing business. In arriving at a premium charge, the first and second step is the computation of what is called a "net premium" which takes into account only the mortality and interest elements. To the net premium is then added an amount called "loading" which is calculated to provide for profit and expenses. The resulting premium, called the "gross premium," is the premium charged to the policyholder.

31. The premium charge for accident and health insurance coverage is computed similarly to a life insurance premium, except that the mortality element of a life insurance premium is replaced by the 'morbidity" element of the accident and health premium (*i.e.*, that part of the premium which provides for the occurrence of the *risk* of the insured becoming disabled because of accident or sickness).

32. Unearned premium reserves on casualty (including accident and health) insurance have traditionally been computed on an unearned *gross* premium basis; *i.e.*, the reserve is calculated as a portion of the entire premium received from the policyholder, including the portion charged to cover expenses and profits ("loading"). The computation of unearned premium reserves on an unearned gross premium basis stems from the historic practice of maintaining unearned premium reserves equal to the aggregate amount of premiums that would have to be refunded if all outstanding policies were canceled. However, the cost of carrying the insurance risk on an accident and health policy is the unexpired portion of the *net* premium charged to the policyholder. That part of the unearned premium reserve which represents the unexpired portion of the "loading" charge is not a true insurance reserve at all, but rather a solvency reserve or reserve for future expenses which in effect requires the reserving company to segregate part of its surplus until the policy has expired.

Life insurance reserves, in contrast to unearned gross premium reserves, are "risk only" reserves and do not include any portion of the loading charge made to the policyholder.

33. The unearned premium reserves of the ceding companies attributed to plaintiff were calculated on an unearned *gross* premium basis. As stipulated by the parties, the following "tabular morbidity reserves" represent the total "net premium" (*i.e.*,

morbidity) element in the unearned gross premium reserves held by the ceding companies (including Old Republic) with respect to disability benefits included in credit life insurance policies issued by the ceding companies to Aetna and its loan customers:

Date	Total Tabular Morbidity Reserves
December 31, 1962	$434,213
December 31, 1963	503,279
December 31, 1964	559,401
December 31, 1965	652,489

However, in view of defendant's concession that no unearned premiums (either net or gross) may be attributed to plaintiff from Old Republic (see finding 15, *supra*) the "net premiums" or "tabular morbidity reserves" in this paragraph have been restated by plaintiff's actuary so as to remove "net premiums" held by Old Republic. Mr. E. Dean Forbes, A.S.A., the actuary who computed the original tabular morbidity reserves appearing in paragraph 57 of the Stipulation of Facts has made this recomputation, removing net premiums held by Old Republic, and leaving only net premiums held by Pilot, National Fidelity, and plaintiff (under its Insurance City treaty).

In accordance with said recomputation, it is found that the following "Tabular Morbidity Reserves" represent the total "net premium" (*i.e.*, morbidity) element in the unearned gross premium reserves reflected on the annual statements of Pilot, National Fidelity, and plaintiff (under the Insurance City Reinsurance Treaty) on December 31, 1962, 1963,

1964, and 1965, respectively, with respect to credit accident and health insurance issued to loan customers of Aetna and its subsidiaries:

Date	Total Tabular Morbidity Reserves
December 31, 1962	$378,238
December 31, 1963	438,390
December 31, 1964	494,819
December 31, 1965	575,216

The above "Tabular Morbidity Reserves" were computed on the basis of the 1964 Commissioners' Disability Table, a recognized morbidity table approved by the National Association of Insurance Commissioners.

34. Plaintiff qualifies as a "life insurance company" within the meaning of Section 801 of the Code for the years 1963 and 1965, even if unearned premium reserves of the ceding companies on disability benefits included in credit life insurance policies issued to Aetna and its loan customers are added to plaintiff's "total reserves" for those years, if the attributed reserves are calculated on a *net* basis. Plaintiff also qualifies as a life insurance company for the year 1964 if attributed reserves are calculated on a *net* basis assuming, however, that plaintiff is entitled to included unpaid losses on credit life insurance in both the numerator and denominator of the life insurance company qualification formula in that year.

Plaintiff's qualification ratio for each of the years in issue, based on a "net premium" attribution, is as follows:

Plaintiff's Qualification Ratios Assuming Attribution of Net Premiums from Pilot and National Fidelity

	Jan 1, 1963	Dec. 31, 1963	Mean
Life Insurance Reserves	$556,923	$733,027	$644,975
Total Reserves	1,036,028	1,302,649	1,169,338
Qualification Ratio (1÷2)			55.1%
	Jan. 1, 1964	Dec. 31, 1964	Mean
Life Insurance Reserves	733,027	806,698	769,863
Total Reserves	1,302,649	1,873,862	1,588,255
Qualification Ratio (1÷2)			48.4%
	Jan. 1, 1965	Dec. 31, 1965	Mean
Life Insurance Reserves	806,698	1,626,902	1,216,800
Total Reserves	1,873,862	2,305,514	2,089,688
Qualification Ratio (1÷2)			58.2%

35. Those credit life insurance policies issued by the ceding companies to Aetna and its loan customers which included disability benefits are sometimes referred to in the insurance industry as life insurance contracts combined with accident and health insurance. They are conceptually identical to combined life, health and accident insurance contracts issued by insurance companies since the early part of this century, which provide payment of the face amount of policies in the event of death, or, if the insured becomes disabled, of installments of the face amount over a period of years.

36. The terms "cancellable" and "noncancellable" have definite and specific meanings in the insurance industry. The National Association of Insurance Commissioners has defined the term "noncancellable" as follows (NAIC, Report to the National Association of Insurance Commissioners Subcommittee on Definition of Non-Cancellable Insurance and Guaranteed Renewable Insurance 156 (1960):

> The terms "noncancellable" or "noncancellable and guaranteed renewable" may be used only in a policy which the insured has the right to continue in force by the timely payment of premiums set forth in the policy (1) until at least age 50, or (2) in the case of a policy issued after the age 44, for at least 5 years from its date of issue, during which period the insurer has no right to make unilaterally any change in any provision of the policy while the policy is in force.

Some accident and health policies are written for the life of the insured at a guaranteed annual premium. A reserve in addition to the unearned premium reserve must be maintained on such policies as a consequence of charging a premium for a benefit that costs increasingly more to provide as the insured grows older. This additional reserve is accumulated from premium payments and interest earnings that will not be needed to pay claims arising during the current policy year of the contract. The reserve is computed on the basis of recognized morbidity tables at an assumed rate of interest. An additional reserve is also required where the policy is written for some term which is shorter than the insured's life where the premium charged provides a benefit that costs increasingly more to provide as the insured grows older. Neither Old Republic, Pilot, nor National Fidelity maintained an additional reserve in addition to the unearned premium reserve with respect to credit accident and health insurance covering debtors of Aetna and its subsidiaries.

Although there is no analogy in life insurance to the unearned gross premium reserve required in casualty insurance, a life insurance reserve may be roughly compared with the unearned *net* premium element in the unearned premium reserve because both are computed on the basis of the actuarial cost of carrying the risk.

Plaintiff's Group Annuity Policy No. 101

37. On December 22, 1965, plaintiff issued Group Annuity Contract No. 101 to the St. Louis Union Trust Company as Trustee of Pension Fund No. 6 of the International Telephone Retirement Plan for Salaried Employees, which contract has remained outstanding and in effect to the present time. On or about December 22, 1965, plaintiff received securities valued at $5,929,057.24 from the St. Louis Union Trust Company for the purchase of single premium annuities for certain retired individuals covered by the International Telephone Retirement Plan for Salaried Employees which obligated plaintiff to pay annuities to such retired individuals (and their spouses, in some cases) under the terms of Group Annuity Contract No. 101. Prior to this transaction, no group annuity or individual annuity contracts had been purchased by IT&T, the St. Louis Union Trust Company, or any Trustee of any pension fund existing under the International Telephone Retirement Plan for Salaried Employees from any insurance company or other person on the lives of the individuals covered under Group Annuity Contract No. 101.

38. Plaintiff maintained a reserve of $6,072,004 on December 31, 1965, with respect to its liabilities under Group Annuity Contract No. 101 on that date. Such reserve was computed on the basis of a recognized mortality table (1951 G.A.) and an assumed rate of interest (3½%), and was set aside to mature or liquidate future unaccrued claims arising under Group Annuity Contract No. 101.

Deficiency Reserves

39. The accepted definition of a deficiency reserve in the insurance industry is the amount by which the present value of the future premiums required (by statute) for a life insurance or annuity contract exceeds the present value of the future premiums and consideration actually charged for such contract.

40. By definition, there can be no deficiency reserve requirement with respect to a life insurance or annuity contract once all premiums called for under such contract have been paid. Thus, there can never be a deficiency reserve required with respect to a single premium life or annuity policy under which the entire premium is payable at the inception of the policy. All of the life and annuity policies reinsured or issued by plaintiff during the years in issue were single premium policies of this type. On an ordinary whole life insurance policy, the deficiency reserve required at the inception of the policy, if any, gradually diminishes as premiums are received by the company. Defendant now concedes this issue.

History of the Controversy

41. For each of the years 1963, 1964, and 1965, plaintiff timely filed with the District Director of Internal Revenue at St. Louis, Missouri, a Federal income tax return on Treasury Form 1120L, U.S. Life Insurance Company tax return, and computed its taxable income and tax as a life insurance company according to Section 802 of the Code. The tax shown to be due on the returns filed for those years, as reported in the table below, was paid in full.

Year	Tax Shown to be Due on Plaintiff's Return
1963	$479,356.02
1964	377,217.70
1965	467,266.14

42. On August 18, 1967, plaintiff filed with the District Director of Internal Revenue at St. Louis, Missouri, claims for refund of income taxes previously paid in respect of the years 1963, 1964, and 1965 (hereinafter referred to as the 1967 claims) in the following amounts:

Year	Amount Claimed	
1963	$156,148.50	(or $143,737.56 in the alternative)
1964	140,482.78	
1965	47,252.76	

Neither the Secretary of the Treasury nor his delegate having theretofore rendered a decision on the 1967 claims, plaintiff, on April 4, 1968, filed suit for a refund of such income taxes in this court.

43. On October 24, 1968, after plaintiff had filed a petition claiming a refund of income taxes paid in

respect of the years 1963, 1964, and 1965 in this court, and prior to a hearing of plaintiff's claims, the Commissioner of Internal Revenue determined deficiencies in plaintiff's income tax for the years 1963, 1964, and 1965 in the following amounts:

Year	Deficiency
1963	$337,376.70
1964	362,986.20
1965	265,412.05

The asserted deficiencies were based upon a determination that plaintiff did not qualify as a life insurance company during the years 1963, 1964, and 1965 under Section 801(a) of the Code, but rather was taxable as an insurance company other than a life or mutual insurance company in those years.

44. Plaintiff did not file a petition with the Tax Court for a redetermination of the asserted deficiencies within the time allowed by Section 6213(a) of the Code, or at any time thereafter. On February 14, 1969, the Commissioner of Internal Revenue assessed the amount of the asserted deficiencies in plaintiff's income tax for the years 1963, 1964, and 1965, together with interest on such deficiencies, and demanded payment thereof. Plaintiff contests the validity of this assessment. On March 5, 1969, the following amounts were paid to the District Director of Internal Revenue at St. Louis, Missouri, under protest, in respect of the deficiencies in plaintiff's income taxes assessed for the years 1963, 1964, and 1965, and interest thereon:

Year	Deficiency	Interest	Total
1963	$337,376.70	$99,747.96	$437,124.66
1964	362,986.20	85,540.43	448,526.63
1965	265,412.05	46,621.63	312,033.26

45. On April 21, 1969, plaintiff filed with the District Director of Internal Revenue at St. Louis, Missouri, claims for refund of the amounts assessed by the Commissioner of Internal Revenue on February 14, 1969, and paid by plaintiff on March 5, 1969, as additional income taxes, and interest thereon, for the years 1963, 1964, and 1965 (hereafter referred to as the 1969 claims). Plaintiff received a formal notice of disallowance of its 1969 claims from said District Director on December 3, 1969, and filed its First Amended Petition with this court on March 30, 1970, seeking recovery of income taxes with respect to both its 1969 and 1967 claims.

46. On May 8, 1969, defendant filed a motion with this court for leave to file an amended answer to plaintiff's petition. Defendant's motion was allowed and an amended answer was filed on July 8, 1969, which amended answer included a counterclaim alleging that the Commissioner of Internal Revenue had assessed additional income taxes and interest for the years 1963, 1964, and 1965 and demanded payment thereof and that such assessment had not been paid. Plaintiff filed a reply to defendant's counterclaim on August 12, 1969, alleging, *inter alia*, full payment of such additional taxes and interest.

47. In its Answer to plaintiff's First Amended Petition defendant stated that "since the Plaintiff has paid the taxes for which the counterclaim was filed

and amended its petition to include a claim for refund for these taxes, a counterclaim by the defendant is no longer necessary, nor required by law." Defendant's Answer to First Amended Petition, Count I ¶ 13(d), Count II, ¶ 11(d), Count III, ¶ 13(d), Count IV, ¶ 13(d).

Ultimate Finding of Fact

48. During each of the years 1963, 1964, and 1965, plaintiff was a life insurance company engaged in the business of issuing or reinsuring life insurance and annuity contracts (issued either separately or combined with accident and health insurance) and its life insurance reserves plus unearned premiums and unpaid losses on non-cancellable life, health or accident policies not included in life insurance reserves comprised more than 50 percent of its total reserves during each of those years within the meaning of Section 801 of the Internal Revenue Code of 1954.

CONCLUSION OF LAW

Upon the foregoing findings of fact which are made a part of the judgment herein, the court concludes as a matter of law that plaintiff is entitled to recover, and judgment is entered to that effect, with the determination of the amount of recovery to be made in further proceedings under Rule 131(c).

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APPENDIX

In the Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1285

UNITED STATES OF AMERICA, PETITIONER

v.

PENN SECURITY LIFE INSURANCE COMPANY

On Writ of Certiorari to the United States Court of Claims

PETITION FOR A WRIT OF CERTIORARI FILED MARCH 9, 1976
CERTIORARI GRANTED MAY 24, 1976

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214-447—76

In the Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1285

UNITED STATES OF AMERICA, PETITIONER

v.

PENN SECURITY LIFE INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

DOCKET ENTRIES

General Docket, Case No. 109-68

ITT HAMILTON LIFE INSURANCE COMPANY, A CORPORATION

Jan 15 1973	Motion to change name to "Penn Security Life Insurance Company" filed.
Apr 4 1968	Filing fee of $10 paid by plaintiff.
Apr 23 1968	Court filed order referring case to Commissioner Vacated.
Jun 2 1968	Defendant's motion for extension of time (to July 3, 1968) to file answer filed. Copies (2) to atty. ALLOWED JUN 19 1968.
Jul 3 1968	Defendant's answer to the petition filed. Copies (2) to atty.
Jul 10 1968	Defendant's answer to petition received. Copies (10) to atty.
May 8 1969	Defendant's motion for leave to file amended answer filed. Copies (2) to atty. ALLOWED JUL 8 1969.
May 22 1969	Plaintiff's motion for extention of time (to June 2, 1969) to respond to motion for leave to file amended answer filed. Copies (2) to deft. ALLOWED MAY 22 1969.

Jun 4 1969	Plaintiff's motion for extension of time (to July 2, 1969) to respond to motion for leave to file amended answer filed. Copies (2) to deft. ALLOWED JUNE 17 1969.
Jul 8 1969	Defendant's amended answer and counterclaim filed. Copies (10) to atty.
Aug 14 1969	Plaintiff's reply to counterclaim filed. Copies (9) to deft.
Nov 19 1969	Court filed order referring case to Commissioner Lloyd Fletcher.
Feb 27 1970	Plaintiff's motion for leave to file amended petition filed. Copies (2) to deft. ALLOWED FEB 27 1970 (amended petition to be filed by March 30, 1970).
Mar 30 1970	Plaintiff's first amended petition filed. Copies (13) to deft.
Apr 29 1970	Defendant's answer to first amended petition filed. Copies (13) to atty.
May 5 1970	Commissioner's standard pretrial order on liability filed. Copy to parties.
Sep 4 1970	Defendant's motion for extension of time (to November 3, 1970) to comply with pretrial order filed. Copies (2) to atty. ALLOWED SEP 4 1970.
Nov 3 1970	Defendant's motion for extension of time (to January 17, 1970) to comply with pretrial order filed. Copies (2) to atty.
Nov 12 1970	Partially allowed in that defendant's time to comply with the pretrial order under Rule 111 is extended to December 28, 1970.
Nov 9 1970	Plaintiff's opposition to motion for time extension filed. Copies (2) to deft.
Dec 28 1970	Defendant's motion for extension of time (to January 12, 1971) to comply with pretrial order filed. Copies (2) to atty. ALLOWED JAN 13 1971.
Jan 11 1971	Defendant's amended motion for extension of time (to January 22, 1971) to comply with pretrial order filed. Copies (2) to atty. ALLOWED JAN 13 1971.
Jan 18 1971	Plaintiff's motion to modify order granting defendant's amended motion for further enlargement of time filed. Copies (2) to deft. DENIED JAN 25 1971 AS MOOT.
Aug 6 1971	Stipulation of facts together with exhibits (attached to the original only) filed by the parties. Copy of stipulation to comr.
Nov 8 1971	Transcript of testimony in one volume (consisting of 181 pages) taken at Washington, D.C. on October 6, 1971 filed. Notice to parties.
Nov 9 1971	Commissioner's order closing proof, etc. filed. Copy to parties. (60–60–20)

Dec 27 1971	Joint motion for leave to file amendments to stipulation of facts and corrections of transcript filed by defendant. Copies (2) to atty. ALLOWED DEC 30 1971.
Dec 30 1971	Correction of transcript filed by defendant. Copies (2) to atty.
Dec 30 1971	Amendment to stipulation of facts filed by defendant. Copies (2) to atty.
Jan 7 1972	Plaintiff's motion for extension of time (to February 7, 1972) to file requested findings, etc. filed. Copies (2) to deft. ALLOWED JAN 10 1972.
Feb 7 1972	Plaintiff's requested findings of fact filed. Copies (2) to deft.
Feb 7 1972	Plaintiff's brief filed. Copies (2) to deft.
Apr 7 1972	Defendant's motion for extension of time (to June 6, 1972) to file findings, etc. filed. Copies (2) to atty. ALLOWED APR 10 1972.
Jun 5 1972	Defendant's motion for extension of time (to July 21, 1972) to file findings, etc. filed. Copies (2) to atty. SEE ENTRY OF JUN 7 1972.
Jun 6 1972	Plaintiff's motion in opposition to motion filed June 5, 1972, filed. Copies (2) to deft.
Jun 7 1972	Re motion of June 5, 1972: Denied in part. Defendant is allowed an extension to June 30, 1972, in which to file brief, requested findings and opposition with no further extension to be granted absent extraordinary cause.
Jun 30 1972	Defendant's motion for extension of time (to July 15, 1972) to file brief filed. Copies (2) to atty. ALLOWED July 3, 1972.
Jul 3 1972	Plaintiff's motion in opposition to defendant's motion for further enlargement of time filed. Copies (2) to deft. DENIED JUL 12 1972.
Jul 17 1972	Defendant's objection to plaintiff's requested findings of fact filed. Copies (2) to atty.
Jul 17 1972	Defendant's requested findindgs of fact filed. Copies (2) to atty.
Jul 17 1972	Defendant's brief to the Commissioner filed. Copies (2) to atty.
Aug 1 1972	Plaintiff's motion for extension of time (to September 11, 1972) to file reply brief, etc., filed. Copies (2) to deft. ALLOWED AUG 2 1972.
Aug 25 1972	Plaintiff's objections to defendant's requested findings, etc. and reply brief for plaintiff filed. Copies (2 of each) to deft.
Jan 15 1973	Notification of change in plaintiff's name [i.e. motion to change caption] (to Penn Security Life Insurance Company) filed. Copies (2) to deft. JAN 31 1973: Notification treated as a motion to identify plaintiff herein by its new name and ALLOWED.

Mar 2 1973	Commissioner's opinion and findings of fact filed. Copies to parties.
Apr 2 1973	Defendant's notice of intention to except filed. Copies (2) to atty.
Apr 13 1973	Defendant's motion for extension of time (to May 31, 1973) to file its exceptions and brief filed. Copies (2) to atty. ALLOWED MAY 7 1975 with no further extension of time to be granted absent a showing of extraordinary cause.
Apr 17 1973	Plaintiff's response to motion for time extension filed. Copies (2) to deft.
Jun 1 1973	Defendant's brief and exceptions filed. Copies (13) to atty. [filed BLOC].
Jul 3 1973	Plaintiff's motion for extension of time (to August 6, 1973) to file brief filed. Copies (2) to deft. ALLOWED JULY 19 1973.
Aug 1 1973	Plaintiff's brief filed. Copies (13) to deft.
Aug 20 1973	Defendant's motion for extension of time (to September 20, 1973) to file reply brief filed. Copies (2) to atty. ALLOWED SEP 7 1973.
Sep 20 1973	Defendant's reply brief filed. Copies (13) to atty.
Dec 5 1973	Argued and submitted on the merits.
Aug 1 1974	Plaintiff's motion for leave to file supplemental statement filed. Copies (2) to deft. ALLOWED AUG 2 1974 provided that defendant is granted to Aug. 29, 1974 to file a response.
Aug 2 1974	Plaintiff's supplemental statement filed. Copies (2) to deft.
Aug 29 1974	Defendant's motion for extension of time (to September 12, 1974) to file response to plaintiff's supplemental statement filed. Copies (2) to atty. ALLOWED SEP 20 1974.
Sept 12 1974	Defendant's motion for extension of time (to September 19, 1974) to file response to plaintiff's supplemental statement filed. Copies (2) to atty. ALLOWED SEP 13 1974.
Sept 18 1974	Defendant's response to plaintiff's supplemental statement filed. Copies (2) to atty.
Dec 18 1974	Court entered order placing this case on the February 1975 Calendar for reargument and submission to the court sitting *en banc*, and further ordering that the parties are to *file simultaneously* on January 17, 1975 supplemental briefs as set forth in the order. Copy to parties and to parties and trial judge in case No. 463–70.
Jan 17 1975	Plaintiff's supplemental brief filed. Copies (3) to deft. and (1) to pltfs. atty. and trial judge in case No. 463–70.

Jan 17 1975	Defendant's supplemental brief filed. Copies (2) to atty. and (1) to pltfs. atty, and trial judge in case No. 463–70.
Jan 20 1975	Plaintiff's consent [to amicus brief] filed. Copies (2) to deft.
Jan 20 1975	Defendant's consent [to amicus brief] filed. Copies (2) to atty.
Jan 20 1975	Brief of Amicus Curiae Consumer Life Insurance Company filed. Copies (2) to parties and (1) to trial judge in case No. 463–70.
Jan 20 1975	Motion of amicus curiae for permission to participate in oral argument filed. Copy to parties. GRANTED JAN 27 1975 in that Consumer Life Insurance Co. may have 15 minutes for oral argument provided that the time allowed plaintiff and defendant for oral argument shall not be changed.
Feb 3 1975	Argued and submitted on the merits [en banc].
Oct 22 1975	Judgment for plaintiff with the amount of recovery to be determined in further proceedings pursuant to Rule 131(c). Opinion Per Curiam. Dissenting opinion by Judge Nichols.
Mar 16 1976	Notice of filing in Supreme Court of a petition for writ of certiorari on March 9, 1976 No. 75–1285, October Term, 1975, filed.
May 27 1976	Order of the Supreme Court, dated May 24, 1976, allowing certiorari filed. Notice to trial judge.
May 27 1976	Record in re certiorari forwarded to Supreme Court.

IN THE UNITED STATES COURT OF CLAIMS

No. 109–68

ITT HAMILTON LIFE INSURANCE COMPANY, A CORPORATION,
PLAINTIFF

v.

THE UNITED STATES OF AMERICA, DEFENDANT

First Amended Petition

(Filed March 30, 1970)

COUNT I

1. Plaintiff claims recovery of income taxes alleged to have been erroneously overpaid and collected under the Internal Revenue Code of 1954 (hereinafter referred to as "the Code")

for the taxable year beginning January 1, 1963, and ending December 31, 1963 (hereinafter referred to as the calendar year 1963). This Court has jurisdiction under 28 U.S.C. sections 1346 (a)(1) and 1491.

2. Plaintiff is a Missouri corporation having its principal office and place of business at 212 South Central Avenue, Clayton, Missouri.

3. (a) Plaintiff was organized and incorporated in the year 1955, under the provisions of Missouri statutes applicable to life insurance companies, for the purpose of engaging in the business of issuing contracts insuring against death or disability occasioned by accident or sickness.

(b) At all material times, the powers granted by plaintiff's Articles of Incorporation, as amended, gave plaintiff the authority necessary to issue contracts insuring against death or disability occasioned by accident or sickness, including contracts reinsuring such risks.

(c) Plaintiff's Articles of Incorporation do not authorize plaintiff to engage in any business other than the business of insuring or reinsuring against death or disability occasioned by accident or sickness, and at all material times plaintiff has engaged solely in such business.

4. During the calendar year 1963, plaintiff was a "Life insurance company" within the meaning of section 801(a) of the Code.

5. During the calendar year 1963, plaintiff's "life insurance reserves" (as referred to in section 801(a)(1) and defined in section 801(b) of the Code) plus plaintiff's unearned premiums and unpaid losses on noncancellable life, health or accident policies not included in life insurance reserves (referred to in section 801(a)(2) of the Code) comprised more than 50 percent of plaintiff's total reserves (as referred to in section 801(a) and defined in section 801(c) of the Code).

6. Pursuant to section 11(d)(2) of the Code (redesignated section 11(e)(2) of the Code by section 121 of P.L. 88–272, effective as of January 1, 1964), plaintiff was subject to Federal income taxation in respect of the calendar year 1963 only under and in the manner provided in section 802 of the Code.

7. For the calendar year 1963, plaintiff timely filed with the District Director of Internal Revenue at St. Louis, Missouri, a Federal income tax return on Treasury Form 1120 L, U.S. Life

Insurance Company tax return computing its taxable income and tax as a life insurance company according to section 802 of the Code, and paid the tax of $479,356.02 shown to be due on the return.

8. The tax shown to be due on plaintiff's return for the calendar year 1963 was overstated in the amount of $143,737.56. The overstatement was due primarily to plaintiff's failure to claim on said return a deduction for "death benefits, etc." in the amount of $120,595.97 to which plaintiff was entitled under section 809(d) of the Code.

9. On August 18, 1967, plantiff filed with the District Director of Internal Revenue at St. Louis, Missouri, a claim for refund, based upon alternative theories, as follows:

(a) On the theory that plaintiff was taxable as an "other Insurance Company" referred to in sections 831 and 832 of the Code, plaintiff computed its tax to be $323,207.52, and claimed a refund of $156,148.50.

(b) On the theory that plaintiff was taxable as a life insurance company under section 802 of the Code, plaintiff computed its tax to be $335,618.46, and claimed refund of $143,737.56. A copy of plaintiff's claim for refund is attached hereto as "Exhibit A", and the facts stated therein are by this reference incorporated herein.

10. Neither the Secretary of the Treasury nor his delegate having theretofore rendered a decision on said claim for refund filed by plaintiff on August 18, 1967, plaintiff, on April 4, 1968, filed suit for a refund of income tax in this Court.

11. On October 24, 1968, after plaintiff had filed a petition claiming a refund of income tax in this Court and prior to the hearing of such suit, the Commissioner of Internal Revenue mailed to plaintiff a statutory notice of deficiency in income tax for the calendar year 1963 in the amount of $307,376.70 and interest thereon in the amount of $99,747.96. The portion of the Statement accompanying the notice of deficiency which purports to explain the assertion of the deficiency reads as follows:

> "It is held that you do not qualify as a life insurance company during the taxable years 1963, 1964 and 1965 within the meaning of Section 801 of the Internal Revenue Code of 1954, per percentage tests as computed in exhibits A and B attached. Your tax liability for these

years has been recomputed, therefore, under the provisions of sections 831 and 832 of the Internal Revenue Code of 1954 as that of an insurance company other than a life or mutual insurance company."

12. Plaintiff did not file a petition with the Tax Court for a redetermination of the asserted deficiency within the time allowed by section 6213(a) of the Code, or at any time thereafter.

13. Defendant did not counterclaim in plaintiff's suit in this Court for the amount of the asserted deficiency, plus interest, within the time provided therefor in section 7422(e) of the Code,

14. On or about February 14, 1969, the Commissioner purported to assess the amount of the asserted deficiency in plaintiff's income tax for the calendar year 1963 of $337,376.70, and the interest thereon in the amount of $99,747.96, and demanded payment thereof.

15. The Commissioner's purported assessment and demand for payment of the said deficiency in income tax and interest was illegal and void in that the United States failed to comply with the procedure provided in section 7422(e) of the Code for the recovery of a deficiency in respect of the same tax which is the subject matter of a suit in this Court.

16. (a) On March 5, 1969, plaintiff paid to the District Director of Internal Revenue, St. Louis, Missouri, the amounts of $337,376.70 and $99,747.96 in respect of the asserted deficiency in plaintiff's income tax for the calendar year 1963, and interest thereon, respectively,

(b) Said payments by plaintiff were made under protest, on the following grounds:

(i) That the purported assessments of said deficiency and interest were illegal and void under Section 7422(e) of the Code; and

(ii) That the determination of said deficiency in any event was erroneous.

17. On April 21, 1969, plaintiff filed with the District Director of Internal Revenue, St. Louis, Missouri, a claim for refund in the amount of $437,124.66 (in addition to the alternative amounts of $156,148.50 or $143,737.56 claimed in plaintiff's claim for refund for the calendar year 1963 filed August 18, 1967). A copy of said claim filed April 21, 1969 is attached

hereto as "Exhibit D", and the facts stated therein are by this reference incorporated herein.

18. On December 3, 1969, plaintiff received from said District Director a formal notice of disallowance of its said claim filed April 21, 1969.

WHEREFORE, plaintiff demands judgment under Count I in the amount of $580,862.2, together with interest and costs as provided by law.

COUNT II.

AN ALTERNATIVE CLAIM IN THE EVENT PLAINTIFF IS HELD NOT TO BE A LIFE INSURANCE COMPANY TAXABLE UNDER SECTION 802 OF THE CODE IN THE CALENDAR YEAR 1963.

1. Plaintiff claims recovery of income taxes alleged to have been erroneously overpaid and collected under the Internal Revenue Code of 1954 (hereinafter referred to as "the Code") for the taxable year beginning January 1, 1963, and ending December 31, 1963 (hereinafter referred to as the calendar year 1963). This Court has jurisdiction under 28 U.S.C. sections 1346(a)(1) and 1491.

2. Plaintiff is a Missouri corporation having its principal office and place of business at 212 South Central Avenue, Clayton, Missouri.

3. (a) Plaintiff was organized and incorporated in the year 1955, under the provisions of Missouri statutes applicable to life insurance companies, for the purpose of engaging in the business of issuing contracts insuring against death or disability occasioned by accident or sickness.

(b) At all material times, the powers granted by plaintiff's Articles of Incorporation, as amended, gave plaintiff the authority necessary to issue contracts insuring against death or disability occasioned by accident or sickness, including contracts reinsuring such risks.

(c) Plaintiff's Articles of Incorporation do not authorize plaintiff to engage in any business other than the business of insuring or reinsuring against death or disability occasioned by accident or sickness, and at all material times plaintiff has engaged solely in such business.

4. During the calendar year 1963, plaintiff was an "insurance company (other than a life or mutual insurance company)" within the meaning of section 831(a)(1) of the Code, and, pursuant to section 11(d)(2) of the Code (redesignated section

11(e)(2) of the Code by section 121 of P.L. 88–272, effective as of January 1, 1964), plaintiff was subject to Federal income taxation in respect of the calendar year 1963 in the manner provided in sections 831 and 832 of the Code.

5. Plaintiff's taxable income as defined in section 832(a) of the Code for the calendar year 1963 was not greater than $636,338.99.

6. For the calendar year 1963, plaintiff timely filed with the District Director of Internal Revenue at St. Louis, Missouri, a Federal income tax return on Treasury Form 1120 L, U.S. Life Insurance Company tax return, computing its taxable income and tax as a life insurance company according to section 802 of the Code, and paid the tax of $479,356.02 shown to be due on the return.

7. On August 18, 1967, plaintiff filed with the District Director of Internal Revenue at St. Louis, Missouri, a claim for refund, based upon alternative theories, as follows:

(a) On the theory that plaintiff was taxable as an "other Insurance Company" referred to in sections 831 and 832 of the Code, plaintiff computed its tax to be $323,207.52, and claimed a refund of $156,148.50.

(b) On the theory that plaintiff was taxable as a life insurance company under section 802 of the Code, plaintiff computed its tax to be $335,618.46, and claimed refund of $143,737.56. A copy of plaintiff's claim for refund is attached hereto as "Exhibit A", and the facts stated therein are by this reference incorporated herein.

8. Neither the Secretary of the Treasury nor his delegate having theretofore rendered a decision on said claim for refund filed by plaintiff on August 18, 1967, plaintiff, on April 4, 1968, filed suit for a refund of income tax in this Court.

9. On October 24, 1968, after plaintiff had filed a petition claiming a refund of income tax in this Court and prior to the hearing of such suit, the Commissioner of Internal Revenue mailed to plaintiff a statutory notice of deficiency in income tax for the calendar year 1963 in the amount of $337,376.70, and interest thereon in the amount of $99,747.96. The portion of the Statement accompanying the notice of deficiency which purports to explain the assertion of the deficiency reads as follows:

> "It is held that you do not qualify as a life insurance company during the taxable years 1963, 1964 and 1965

within the meaning of section 801 of the Internal Revenue Code of 1954, per percentage tests as computed in exhibits A and B attached. Your tax liability for those years has been recomputed, therefore, under the provisions of sections 831 and 832 of the Internal Revenue Code of 1954 as that of an insurance company other than a life or mutual insurance company."

10. Plaintiff did not file a petition with the Tax Court for a redetermination of the asserted deficiency within the time allowed by section 6213(a) of the Code, or at any time thereafter.

11. Defendant did not counterclaim in plaintiff's suit in this Court for the amount of the asserted deficiency, plus interest, within the time provided therefor in section 7422(e) of the Code.

12. On or about February 14, 1969, the Commissioner purported to assess the amount of the asserted deficiency in plaintiff's income tax for the calendar year 1963 of $337,376.70, and interest thereon in the amount of $99,747.96, and demanded payment thereof.

13. The Commissioner's purported assessment and demand for payment of the said deficiency in income tax and interest was illegal and void in that the United States failed to comply with the procedure provided in section 7422(e) of the Code for the recovery of a deficiency in respect of the same tax which is the subject matter of a suit in this Court.

14. (a) On March 5, 1969, plaintiff paid to the District Director of Internal Revenue, St. Louis, Missouri, the amounts of $337,376.70 and $99,747.96 in respect of the asserted deficiency in plaintiff's income tax for the calendar year 1963, and interest thereon, respectively.

(b) Said payments by plaintiff were made under protest, on the following grounds:

(i) That the purported assessments of said deficiency and interest were illegal and void under Section 7422(e) of the Code; and

(ii) That the determination of said deficiency in any event was erroneous.

15. On April 21, 1969, plaintiff filed with the District Director of Internal Revenue, St. Louis, Missouri, a claim for refund in the amount of $437,124.66 (in addition to the alternative amounts of $156,148.50 or $143,737.56 claimed in plaintiff's

claim for refund for the calendar year 1963 filed August 18, 1967). A copy of said claim field April 21, 1969 is attached hereto as "Exhibit D", and the facts stated therein are by this reference incorporated herein.

16. On December 3, 1969, plaintiff received from said District Director a formal notice of disallowance of its said claim filed April 21, 1969.

WHEREFORE, plaintiff demands judgment under Count II in the amount of $593,273.16, together with interest and costs as provided by law.

COUNT III.

1. Plaintiff claims recovery of income taxes alleged to have been erroneously overpaid and collected under the Internal Revenue Code of 1954 (hereinafter referred to as "the Code") for the taxable year beginning January 1, 1964, and ending December 31, 1964 (hereinafter referred to as the calendar year 1964). This Court has jurisdiction under 28 U.S.C. sections 1346(a)(1) and 1491.

2. Plaintiff is a Missouri corporation having its principal office and place of business at 212 South Central Avenue, Clayton, Missouri.

3. (a) Plaintiff was organized and incorporated in the year 1955, under the provisions of Missouri statutes applicable to life insurance companies, for the purpose of engaging in the business of issuing contracts insuring against death or disability, occasioned by accident or sickness.

(b) At all material times, the powers granted by plaintiff's Articles of Incorporation, as amended, gave plaintiff the authority necessary to issue contracts insuring again death or disability occasioned by accident or sickness, including contracts reinsuring such risks.

(c) Plaintiff's Articles of Incorporation do not authorize plaintiff to engage in any business other than the business of insuring or reinsuring against death or disability occasioned by accident or sickness, and at all material times plaintiff has engaged solely in such business.

4. During the calendar year 1964, plaintiff was a "life insurance company" within the meaning of section 801(a) of the Code.

5. During the calendar year 1964, plaintiff's "life insurance reserves" (as referred to in section 801(a)(1) and defined in

section 801(b) of the Code) plus plaintiff's unearned premiums and unpaid losses on noncancellable life, health or accident policies not included in life insurance reserves (referred to in section 801(a)(2) of the Code) comprised more than 50 percent of plaintiff's total reserves (as referred to in section 801(a) and defined in section 801(c) of the Code).

6. Pursuant to section 11(e)(2) of the Code, plaintiff was subject to Federal income taxation in respect of the calendar year 1964 only under and in the manner provided in section 802 of the Code.

7. For the calendar year 1964, plaintiff timely filed with the District Director of Internal Revenue at St. Louis, Missouri, a Federal income tax return on Treasury Form 1120 L, U.S. Life Insurance Company tax return, computing its taxable income and tax as a life insurance company according to section 802 of the Code, and paid the tax of $377,217.70 shown to be due on the return.

8. The tax shown to be due on plaintiff's return for the calendar year 1964 was overstated in the amount of $140,482.78. The overstatement was due primarily to plaintiff's failure to claim on said return a deduction for "death benefits, etc." in the amount of $555,605.11 to which plaintiff was entitled under section 809(d) of the Code.

9. On August 18, 1967, plaintiff filed with the District Director of Internal Revenue at St. Louis, Missouri, a claim for refund in the amount of $140,482.78. A copy of plaintiff's claim for refund is attached hereto as "Exhibit 8", and the facts stated therein are by this reference incorporated herein.

10. Neither the Secretary of the Treasury nor his delegate having theretofore rendered a decision on said claim for refund filed by plaintiff on August 18, 1967, plaintiff, on April 4, 1968, filed suit for a refund of income tax in this Court.

11. On October 24, 1968, after plaintiff had filed a petition claiming a refund of income tax in this Court and prior to the hearing of such suit, the Commissioner of Internal Revenue mailed to plaintiff a statutory notice of deficiency in income tax for the calendar year 1964 in the amount of $362,986.20, and interest thereon in the amount of $85,540.43. The portion of the Statement accompanying the notice of deficiency which

purports to explain the assertion of the deficiency reads as follows:

> "It is held that you do not qualify as a life insurance company during the taxable years 1963, 1964 and 1965 within the meaning of section 801 of the Internal Revenue Code of 1954, per percentage tests as computed in Exhibits A and B attached. Your tax liability for those years has been recomputed, therefore, under the provisions of sections 831 and 832 of the Internal Revenue Code of 1954 as that of an insurance company other than a life or mutual insurance company."

12. Plaintiff did not file a petition with the Tax Court for a redetermination of the asserted deficiency within the time allowed by section 6213(a) of the Code, or at any time thereafter.

13. Defendant did not counterclaim in plaintiff's suit in this Court for the amount of the asserted deficiency, plus interest, within the time provided therefor in section 7422(e) of the Code.

14. On or about February 14, 1969, the Commissioner purported to assess the amount of the asserted deficiency in plaintiff's income tax for the calendar year 1964 of $362,986.20, and the interest thereon in the amount of $85,540.43, and demanded payment thereof.

15. The Commissioner's purported assessment and demand for payment of the said deficiency in income tax and interest was illegal and void in that the United States failed to comply with the procedure provided in section 7422(e) of the Code for the recovery of a deficiency in respect of the same tax which is the subject matter of a suit in this Court.

16. (a) On March 5, 1969, plaintiff paid to the District Director of Internal Revenue, St. Louis, Missouri, the amounts of $362,986.20 and $85,540.43 in respect of the asserted deficiency in plaintiff's income tax for the calendar year 1964, and interest thereon, respectively.

(b) Said payments by plaintiff were made under protest, on the following grounds:

> (i) That the purported assessments of said deficiency and interest were illegal and void under section 7422(e) of the Code; and

(ii) That the determination of said deficiency in any event was erroneous.

17. On April 21, 1969, plaintiff filed with the District Director of Internal Revenue, St. Louis, Missouri, a claim for refund in the amount of $448,526.63 (in addition to the amount of $148,-482.78 claimed in its prior claim for refund for the calendar year 1964 filed August 18, 1967). A copy of said claim filed on April 21, 1969 is attached hereto, marked "Exhibit E", and the facts stated therein are by this reference incorporated herein.

18. On December 3, 1969, plaintiff received from said District Director a formal notice of disallowance of its said claim filed April 21, 1969.

WHEREFORE, plaintiff demands judgment under Count III in the amount of $589,009.41, together with interest and costs as provided by law.

COUNT IV.

1. Plaintiff claims recovery of income taxes alleged to have been erroneously overpaid and collected under the Internal Revenue Code of 1954 (hereinafter referred to as "the Code") for the taxable year beginning January 1, 1965, and ending December 31, 1965, (hereinafter referred to as the calendar year 1965). This Court has jurisdiction under 28 U.S.C. sections 1346(a)(1) and 1491.

2. Plaintiff is a Missouri corporation having its principal office and place of business at 212 South Central Avenue, Clayton, Missouri.

3. (a) Plaintiff was organized and incorporated in the year 1955, under the provisions of Missouri statutes applicable to life insurance companies, for the purpose of engaging in the business of issuing contracts insuring against death or disability occasioned by accident or sickness.

(b) At all material times, the powers granted by plaintiff's Articles of Incorporation, as amended, gave plaintiff the authority necessary to issue contracts insuring against death or disability occasioned by accident or sickness, including contracts reinsuring such risks.

(c) Plaintiff's Articles of Incorporation do not authorize plaintiff to engage in any business other than the business of insuring or reinsuring against death or disability occasioned by accident or sickness, and at all material times plaintiff has engaged solely in such business.

4. During the calendar year 1965, plaintiff was a "life insurance company" within the meaning of section 801(a) of the Code.

5. During the calendar year 1965, plaintiff's "life insurance reserves" (as referred to in section 801(a)(1) and defined in section 801(b) of the Code), plus plaintiff's unearned premiums and unpaid losses on noncancellable life, health or accident policies not included in life insurance reserves (referred to in section 801(a)(2) of the Code) comprised more than 50 percent of plaintiff's total reserves (as referred to in section 801(a) and defined in section 801(c) of the Code).

6. Pursuant to section 11(e)(2) of the Code plaintiff was subject to Federal income taxation in respect of the calendar year 1965 only under and in the manner provided in section 802 of the Code.

7. For the calendar year 1965, plaintiff timely filed with the District Director of Internal Revenue at St. Louis, Missouri, a Federal income tax return on Treasury Form 1120 L, U.S. Life Insurance Company tax return, computing its taxable income and tax as a life insurance company according to section 802 of the Code, and paid the tax of $467,266.14 shown to be due on the return.

8. The tax shown to be due on plaintiff's return for the calendar year 1965, was overstated in the amount of $47,252.76. The overstatement was due primarily to an overstatement of gross premiums earned by plaintiff during the calendar year 1965.

9. On August 18, 1967, plaintiff filed with the District Director of Internal Revenue at St. Louis, Missouri, a claim for refund in the amount of $47,252.76. A copy of plaintiff's claim for refund is attached hereto as "Exhibit C", and the facts stated therein are by this reference incorporated herein.

10. Neither the Secretary of the Treasury nor his delegate having theretofore rendered a decision on said claim for refund filed by plaintiff on August 18, 1967, plaintiff, on April 4, 1968, filed suit for a refund of income tax in this Court.

11. On October 24, 1968, after plaintiff had filed a petition claiming a refund of income tax in this Court and prior to the hearing of such suit, the Commissioner of Internal Reveune mailed to plaintiff a statutory notice of deficiency in income tax for the calendar year 1965 in the amount of $265,412.05, and in-

terest thereon in the amount of $46,621.63. The portion of the Statement accompanying the notice of deficiency which purports to explain the assertion of the deficiency reads as follows:

> "It is held that you do not qualify as a life insurance company during the taxable years 1963, 1964 and 1965 within the meaning of Section 801 of the Internal Revenue Code of 1954, per percentage tests as computed in exhibits A and B attached. Your tax liability for those years has been recomputed, therefore, under the provisions of sections 931 and 932 of the Internal Revenue Code of 1954 as that of an insurance company other than a life or mutual insurance company."

12. Plaintiff did not file a petition with the Tax Court for a redetermination of the asserted deficiency within the time allowed by section 6213(a) of the Code, or at any time thereafter.

13. Defendant did not counterclaim in plaintiff's suit in this Court for the amount of the asserted deficiency, plus interest, within the time provided therefor in section 7422(e) of the Code.

14. On or about February 14, 1969, the Commissioner purported to assess the amount of the asserted deficiency in plaintiff's income tax for the calendar year 1965 of $265,412.05, and the interest thereon in the amount of $46,621.63, and demanded payment thereof.

15. The Commissioner's purported assessment and demand for payment of the said deficiency in income tax and interest was illegal and void in that the United States failed to comply with the procedure provided in section 7422(e) of the Code for the recovery of a deficiency in respect of the same tax which is the subject matter of a suit in this Court.

16. (a) On March 5, 1969, plaintiff paid to the District Director of Internal Revenue, St. Louis, Missouri, the amounts of $265,412.05 and $46,621.63 in respect of the asserted deficiency in plaintiff's income tax for the calendar year 1965, and interest thereon, respectively.

(b) Said payments by plaintiff were made under protest, on the following grounds:

(i) That the purported assessments of said deficiency and interest were illegal and void under section 7422(e) of the Code; and

(ii) That the determination of said deficiency in any event was erroneous.

17. On April 21, 1969, plaintiff filed with the District Director of Internal Revenue, St. Louis, Missouri, a claim for refund in the amount of $312,033.68 (in addition to the amount of $47,252.76 claimed in its prior claim for refund for the calendar year 1965 filed August 18, 1967). A copy of said claim filed April 21, 1969 is attached hereto, marked "Exhibit F", and the facts stated therein are by this reference incorporated herein.

18. On December 3, 1969, plaintiff received from said District Director a formal notice of disallowance of said claim filed April 21, 1969.

WHEREFORE, plaintiff demands judgment under Count IV in the amount of $359,286.44, together with interest and costs as provided by law.

Owen T. Armstrong
OWEN T. ARMSTRONG,
Attorney for Plaintiff.
LOWENHAUPT, CHASNOFF, FREEMAN & HOLLAND
408 Olive Street
St. Louis, Missouri 63102
(314) 241–5950

Of Counsel
JOHN T. SAPIENZA
JOHN B. JONES, JR.
ANDREW W. SINGER
Covington & Burling
888 Sixteenth Street, N.W.
Washington, D.C. 20006
(202) 293–3300

Plaintiff's Post Office Address:
ITT Hamilton Life Insurance Company
212 South Central Avenue
Clayton, Missouri 63105

EXHIBIT A

FORM 843 (Rev. July 1963)

U.S. TREASURY DEPARTMENT INTERNAL REVENUE SERVICE

CLAIM

TO BE FILED WITH THE DISTRICT DIRECTOR WHERE ASSESSMENT WAS MADE OR TAX PAID

RECEIVED
AUG 18 1967
CONTACT SECTION
DISTRICT DIRECTOR
INTERNAL REVENUE SERVICE
ST. LOUIS, MO.

The District Director will indicate in the block below the kind of claim filed, and fill in, where required.

- ☐ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
- ☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- ☐ Abatement of Tax Assessed (not applicable to estate, gift, or chrome taxes).

PLEASE TYPE OR PRINT PLAINLY

Name of taxpayer or purchaser of stamps
ITT Life Insurance Company

Number and street
212 South Central

City, town, state, and ZIP Code
St. Louis, Missouri 63105

Fill in applicable items. Attach letter size sheets if space is not sufficient

a. Your social security number | Wife's number, if joint return | b. If an employer, enter employer identification number
43-0712326

c. District in which return (if any) was filed
St. Louis, Missouri

d. Name and address shown on return, if different from above
American Universal Life Insurance Company
111 South Meramec, Clayton, Missouri 63105

e. Period—If tax is reported on an annual basis, prepare separate form for each taxable year
From January 1, 1963, to December 31, 1963

f. Kind of tax
Income Tax

g. Amount of assessment
$ 479,356.02

Dates of payment
9/13/63 ($150,000.00) 3/13/64 ($99,678.01)
12/ 2/63 ($150,000.00) 6/22/64 ($79,678.01)

h. Date stamps were purchased from Government

i. Amount to be refunded (if income tax, complete computation below)
$ 156,148.50*

j. Amount to be abated (not applicable to income, estate, or gift taxes)
$

k. The statement below sets forth the reasons why this claim should be allowed for the following reasons:

On the theory that the Company is to be taxed as an "Other Insurance Company" under sections 831 and 832 (a theory disputed by the Company), the Company computes the tax as $323,207.52. This is the basis of the amount to be refunded shown at item i. The attached Exhibit A summarizes the changes which produce taxable income.

Being taxable as a Life Insurance Company under sections 801 through 820 (the theory affirmed by the Company), the Company computes the tax as $559,818.40. The attached Exhibit B summarizes the changes from Form 1120L as originally filed for calendar year 1963.

See the attached statement of reasons for claim under each theory.

* or such greater amount as may be legally refundable, with interest.

COMPUTATION OF INCOME TAX REFUND	Income Tax
1. Tax withheld	0
2. Estimated tax paid	300,000.00
3. Tax paid with original return	179,356.02
4. Any additional income tax paid	0
5. Total tax paid (Add lines 1-4)	479,356.02
6. Less: Your computation of correct tax	323,207.52
7. Amount of overpayment	156,148.50
8. Amount previously refunded	0
9. Net overpayment (Enter in item i above)	156,148.50

Under penalties of perjury, I declare that this claim, including any accompanying schedules and statements, has been examined by me and to the best of my knowledge and belief it is true and correct.

Signed ITT Life Insurance Company

Dated Aug. 16, 1967 By Gerald M. Ritter, Vice Pres. & Treas.

SEE INSTRUCTIONS ON REVERSE

FORM 843 (Rev. 7-63)

BEST COPY AVAILABLE

EXHIBIT A

ITT Life Insurance Company Caim for Refund—1963

1. Recomputed gain from operations (See Exhibit B)	$1, 238, 623. 29
2. Small business deduction	9, 831. 89
3. Deduction for A & H and Group Life Premiums	34, 932. 84
4. Increase in claim liability	120, 595, 97
5. Tabular life insurance reserves 12/31/63	733, 027. 00
6. Unearned life insurance premiums 12/31/63	(1, 500, 672. 00)
7. Taxable Income	636, 338. 99

EXHIBIT B

ITT Life Insurance Company Claim for Refund—1963

1. Accrual of discount	$8, 626. 68		
2. Accrued interest 12/31/63			351. 57
3. Net long term capital gain			8, 106. 25
4. Gross premiums			167. 04
5. Increase in reserves			6, 110. 54
6. Death benefits, etc	120, 595. 97		
7. Small business deduction			837. 51
8. Other deductions.	313. 69		
Decrease in gain from operations		$113, 973. 43	
Gain from operations as originally filed		1, 352, 596. 72	
Recomputed gain from operations		1, 238, 623. 29	

Two related changes are:		
9. Amounts subtracted from policyholders surplus	215,947.33	
10. Taxable investment income...		3,636.15

STATEMENT OF REASONS FOR CLAIM

I. *Section 831 Theory*

Taxpayer filed its return on Form 1120L as a life insurance company taxable under Sections 801 and following. The agent has asserted that taxpayer is an insurance company other than life or mutual, taxable under Section 831 and following. Taxpayer contends that if the agent's theory were correct, taxpayer's correct taxable income would be only $636,338.99, the correct tax would be $323,207.52, and taxpayer would be entitled to a refund of $156,148.50. The supporting figures are shown on Exhibit A attached to this claim. The principal element involved in these computations is the spread between life insurance "unearned premiums," the amounts of which taxpayer contends were $556,923.00 at December 31, 1962 (by stipulation in a compromise settlement of tax liability for the year 1962) and $1,500,672.00 at December 31, 1963, as determined under Section 832(b)(4).

II. *Section 801 Theory*

Taxpayer filed its return as a life insurance company, computed its gain from operations to be $1,352,596.72, and its tax to be $479,356.02. Taxpayer now contends that it is entitled to certain adjustments as shown in Exhibit B attached to this claim. The principal item is "death benefits, etc." in the amount of $120,595.97, deductible under Section 809(d), The adjustments shown in Exhibit B result in recomputed gain from operations of $1,238,623.29, and a tax of $335,618.46.

A prior claim in the amount of $60,687.10, involving a similar contention was filed and disallowed.

The tax computation also takes into account that, as a result of a compromise settlement of tax liability for prior years,

taxpayer's policyholders' surplus account as of January 1, 1963, is reduced from $215,947.33 to zero, also as shown on Exhibit B.

EXHIBIT B

Form 843 (Rev. July 1963)

U.S. TREASURY DEPARTMENT INTERNAL REVENUE SERVICE

CLAIM

TO BE FILED WITH THE DISTRICT DIRECTOR WHERE ASSESSMENT WAS MADE OR TAX PAID

RECEIVED
AUG 18 1967
CONTACT SECTION
DISTRICT DIRECTOR
INTERNAL REVENUE SERVICE
ST. LOUIS, MO.

The District Director will indicate in the block below the kind of claim filed, and fill in, where required.

- ☐ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
- ☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- ☐ Abatement of Tax Assessed (not applicable to estate, gift, or excise taxes).

PLEASE TYPE OR PRINT PLAINLY

Name of taxpayer or purchaser of stamps
ITT Life Insurance Company

Number and street
212 South Central

City, town, State, Postal ZIP Code
St. Louis, Missouri 63105

Fill in applicable items. Mark (X) all boxes that do not apply.

a. Taxpayer social security number | Wife's number, if joint return | b. If an employer, enter employer identification number
43-0712326

c. District in which return (if any) was filed
St. Louis, Missouri

d. Name and address shown on return, if different from above
American Universal Life Insurance Company
111 South Hanley, Clayton, Missouri 63105

e. Period—if tax was reported on annual basis, prepare separate form for each taxable year
From January 1, 1964 To December 31, 1964

f. Kind of tax
Income Tax

g. Amount of assessment
$ 377,217.70

h. Date of payment
4/14/64($4,430.00), 6/5/64($6,000.00), 9/15/64 ($125,000.00), 12/15/64($220,000.00), 3/15/65($21,787.70)

i. State where return was filed
Corporation

j. Amount to be refunded (if amount less than assessment, complete computation below)
$ 140,482.78*

k. Amount to be abated (not applicable to income, estate, or gift taxes)
$

l. The claimant believes that the taxes should be allowed for the following reasons:

On the theory that the Company is to be taxed as a Life Insurance Company under sections 801 through 820 (a theory affirmed by the Company) the Company computes the tax as $236,734.92. This is the basis of the amount to be refunded shown at item i. The attached Exhibit A summarizes the changes from Form 1120L as originally filed for calendar year 1964

See attached statement of reasons for claim.

*For such greater amount as may be legally refundable, with interest.

COMPUTATION OF INCOME TAX REFUND	Income Tax
1. Tax withheld	0
2. Estimated tax paid	355,430.00
3. Tax paid with original return	21,787.70
4. Any additional amount tax paid	0
5. Total tax paid (Add lines 1-4)	377,217.70
6. Less: Your computation of correct tax	236,734.92
7. Amount of overpayment	140,482.78
8. Amount previously refunded	0
9. Net overpayment (Enter in item i above)	140,482.78

Under penalties of perjury, I declare that this claim, including any accompanying schedules and statements, has been examined by me and to the best of my knowledge and belief it is true and correct.

Signed ITT Life Insurance Company

Dated Aug 15, 1967 By Glenn H. Donlon, Vice Pres & Treas

See instructions on reverse

Form 843 (Rev. 7-63)

EXHIBIT A

ITT Life Insurance Company
Claim for Refund—1964

1. Accrual of discount	$7,547.32		
2. Accrued interest 12/31/63	351.57		
3. Net long term capital gain			$375.00
4. Gross premiums	8,813.36		
5. Death benefits, etc	555,605.11		
6. Increase in reserves			10,931.37
7. Small business deduction			789.89
8. Other deductions	1,032.36		
Decrease in gain from operations		$561,253.46	
Gain from operations as originally filed		1,429,191.57	
Recomputed gain from operations		867,938.11	

STATEMENT OF REASONS FOR CLAIM

Taxpayer filed its return as a life insurance company, computed its gain from operations to be $1,429,191.57, and its tax to be $377,217.70. Taxpayer now contends that it is entitled to certain adjustments as shown in Exhibit A. The principal item is "death benefits, etc." in the amount of $555,605.11 deductible under Section 809(d).

The adjustments shown in Exhibit A result in recomputed gain from operations of $867,938.11 and a tax of $236,734.92.

A prior claim in the amount of $136,162.68, involving a similar contention was filed and disallowed.

EXHIBIT C

Form 843 (Rev. July 1963)

U.S. TREASURY DEPARTMENT INTERNAL REVENUE SERVICE

CLAIM

TO BE FILED WITH THE DISTRICT DIRECTOR WHERE ASSESSMENT WAS MADE OR TAX PAID

RECEIVED
AUG 18 1967
CONTACT SECTION
DISTRICT DIRECTOR
INTERNAL REVENUE SERVICE
ST. LOUIS, MO.

The District Director will indicate in the block below the kind of claim filed, and fill in, where required.

- ☐ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
- ☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- ☐ Abatement of Tax Assessed (not applicable to estate, gift, or income taxes).

PLEASE TYPE OR PRINT PLAINLY

Name of taxpayer or purchaser of stamps
ITT Life Insurance Company

Number and street
212 South Central

City, town, State, Postal ZIP Code
St. Louis, Missouri 63105

Fill in applicable items—Attach further size sheets if space is not sufficient

a. Your social security number | Wife's number, if joint return | b. If an employer, enter employer identification number
43-0712360

c. District in which return (if any) was filed
St. Louis, Missouri

d. Name and address shown on return, if different from above
American Universal Life Insurance Company
111 South Bemiss, Clayton, Missouri 63105

e. Period—if tax was reported on annual basis, prepare separate form for each taxable year
From January 1, 1965 To December 31, 19 65

f. Kind of tax
Income Tax

g. Amount of assessment
$ 497,260.14

Dates of payment
4/14/65 ($10,000.00), 6/14/65 ($10,000.00), 9/8/65 ($100,000.00), 12/6/65 ($100,000.00), 3/14/66 ($117,633.07).

h. Date stamps were purchased from Government

i. Amount to be refunded (if income tax, complete computation below)
$ 47,252.76*

j. Amount to be abated (not applicable to income, estate, or gift taxes)
$

6/13/66 ($117,633.07).

k. The claimant believes that this claim should be allowed for the following reasons:

On the theory that the Company is to be taxed as a Life Insurance Company under sections 801 through 820 (a theory affirmed by the Company), the Company computed the tax as $470,013.36. This is the basis of the amount to be refunded shown at item i. The attached Exhibit A summarizes the changes from Form 1120L as originally filed for calendar year 1965.

See attached Statement of Reasons for Claim.

*or such greater amount as may be legally refundable, with interest.

COMPUTATION OF INCOME TAX REFUND	Income Tax
1. Tax withheld	0
2. Estimated tax paid	232,000.00
3. Tax paid with original return	235,260.14
4. Any additional income tax paid	0
5. Total tax paid (Add lines 1–4)	497,260.14
6. Less: Your computation of correct tax	420,013.38
7. Amount of overpayment	47,252.76
8. Amount previously refunded	0
9. Net overpayment (Enter on item i above)	47,252.76

Under penalties of perjury, I declare that this claim, including any accompanying schedules and statements, has been examined by me and to the best of my knowledge and belief it is true and correct.

Signed ITT Life Insurance Company

Date Aug 18, 1967 By Edward M. Lawton, Vice-Pres. & Treas.

SEE INSTRUCTIONS ON REVERSE

FORM 843 (Rev. 7-63)

EXHIBIT A

ITT Life Insurance Company Claim for Refund—1965

1. Accrual of discount	$8,795.14		
2. Accrued interest 12/31/65	28,828.32		
3. Accrued interest purchased	1,452.50		
4. Net long term capital gain			4,734.37
5. Gross premiums	121,100.08		
6. Death benefits, etc	30,000.00		
7. Increase in reserves			2,679.94
8. Small business deduction			3,065.75
9. Other deductions	558.01		
Decrease in gain from operations		$180,253.99	
Gain from operations as originally filed		1,839,700.09	
Recomputed gain from operations		1,659,446.10	

STATEMENT OF REASONS FOR CLAIM

Taxpayer filed its return as a life insurance company, computed its gain from operations to be $1,839,700.09 and its tax to be $467,266.14. Taxpayer now contends that it is entitled to certain adjustments as shown in Exhibit A. The principal item is a reduction of gross premiums, resulting from corrections of the amounts of unearned premiums on accident and health insurance at the beginning and end of the taxable period, respectively.

The adjustments shown in Exhibit A result in recomputed gain from operations of $1,659,466.10, and a tax of $420,013.38.

Exhibit D

FORM 843 (Rev. July 1963)

U.S. TREASURY DEPARTMENT - INTERNAL REVENUE SERVICE

CLAIM

TO BE FILED WITH THE DISTRICT DIRECTOR WHERE ASSESSMENT WAS MADE OR TAX PAID

District Director's Stamp (Date Received)

RECEIVED
APR 21 1969
DIRECTOR INT REV
ST. LOUIS

The District Director will indicate in the block below the kind of claim filed, and fill in, where required.

- ☐ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
- ☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- ☐ Abatement of Tax Assessed (not applicable to estate, gift, or income taxes).

43

PLEASE TYPE OR PRINT PLAINLY

Name of taxpayer or purchaser of stamps
ITT Hamilton Life Insurance Company

Number and street
212 South Central Avenue

City, town, State, Postal ZIP Code
St. Louis, Missouri 63105

Fill in applicable items—Attach letter size sheets if space is not sufficient

a. Your social security number | Wife's number, if joint return | b. If an employer, enter employer identification number
43-0712326

c. District in which return (if any) was filed
St. Louis, Missouri

d. Name and address shown on return, if different from above
American Universal Life Insurance Company
111 South Meramec, Clayton, Missouri 63105

e. Period—if for tax reported on annual basis, prepare separate form for each taxable year
From January 1, 1963 To December 31, 1963

f. Kind of tax
Income

g. Amount of assessment
$ 437,124.66

Dates of payment
March 5, 1969

h. Date stamps were purchased from Government

i. Amount to be refunded (if income tax, complete computation below)
$ 437,124.66 * #

j. Amount to be abated (not applicable to income, estate, or gift taxes)
$

k. The claimant believes that this claim should be allowed for the following reasons:

See statement attached.

*plus $156,148.50 per claim filed August 18, 1967, or such greater amount as may be legally refundable, with statutory interest.

COMPUTATION OF INCOME TAX REFUND	Income Tax
1. Tax withheld	0
2. Estimated tax paid	300,000.00
3. Tax paid with original return	179,350.02
# 4. Any additional income tax paid including $99,747.96 assessed interest	437,124.66
5. Total tax paid (Add lines 1-4)	916,474.68
6. Less: Your computation of correct tax	323,207.52
7. Amount of overpayment	593,273.16
8. Amount ~~overpaid~~ to be refunded per claim filed 8/18/67	156,148.50
9. Net overpayment (Enter on item i above) claimed herein	437,124.66

Under penalties of perjury, I declare that this claim, including any accompanying schedules and statements, has been examined by me and to the best of my knowledge and belief it is true and correct

Signed ITT HAMILTON LIFE INSURANCE COMPANY
(and on behalf of the above)

Dated April 18, 1969 By: Robert Ritter, Chief Executive Officer

SEE INSTRUCTIONS ON REVERSE

FORM 843 (Rev. 7-63)

STATEMENT OF REASONS FOR CLAIM

1. On March 5, 1969, taxpayer paid $437,124.66 to the District Director of Internal Revenue, St. Louis, Missouri, consisting of $337,376.70 in tax, and $99,747.96 in assessed interest, pursuant to notice and demand for payment. Said payment was made under protest on the following grounds, which constitute the first reason for this claim for refund.

On August 18, 1967, taxpayer filed a claim for refund of $156,148.50 in 1963 income taxes. No action having been taken by the Secretary or his delegate to allow or disallow said claim, taxpayer on April 4, 1968, filed suit for refund in the United States Court of Claims. Said suit is now pending, No. 109–68.

On October 24, 1968, at a time when said suit for refund was pending, the Commissioner of Internal Revenue mailed to taxpayer a statutory notice of deficiencies, including a deficiency in income tax for the year 1963 in the amount of $337,376.70. After the lapse of more than 90 days from and after October 24, 1968, the Commissioner purported to assess said deficiency, notice of said alleged assessment was given and demand for payment thereof was made.

Section 7422(e), Internal Revenue Code of 1954, provides in material part as follows:

> "If the Secretary or his delegate prior to the hearing of a suit brought by a taxpayer in * * * the Court of Claims for the recovery of any income tax * * * mails to the taxpayer a notice that a deficiency has been determined in respect of the tax which is the subject matter of taxpayer's suit, the proceedings in taxpayer's suit shall be stayed during the period of time in which the taxpayer may file a petition with the Tax Court for a redetermination of the asserted deficiency, and for 60 days thereafter. * * * If the taxpayer does not file a petition with the Tax Court for a redetermination of the asserted deficiency, the United States may counterclaim in the taxpayer's suit * * * within the period of the stay of proceedings. * * *"

As applied to this case, this means that the proceedings in taxpayer's Court of Claims Suit No. 109–68 were stayed until March 23, 1969, and the United States might have counterclaimed for the aforementioned asserted deficiency at any time

after January 22 and/on or prior to March 23, 1969. It did not do so.

Therefore, taxpayer contends that said alleged assessment of deficiency pursuant to notice and demand for payment of which taxpayer, on March 5, 1969, paid under protest the said sum of $437,124.66, is illegal and void, the sole legal means of collection of said asserted deficiency having been by counterclaim in said Court of Claims suit, as provided in Section 7422(e).

2. Secondly the Commissioner erred in determining said deficiency of $337,376.70, of which notice was given October 24, 1968. Said determination is predicated upon the holding that taxpayer for its taxable year ended December 31, 1963, did not qualify as a life insurance company within the meaning of Section 801 of the Internal Revenue Code of 1954, but was taxable under Sections 831 and 832 as an insurance company other than a life or mutual insurance company. Taxpayer contends that it did qualify as a life insurance company under the statutory test, and is therefore taxable as such for the year 1963.

Exhibit E

Form 843 (Rev. July 1963)

U.S. TREASURY DEPARTMENT - INTERNAL REVENUE SERVICE

CLAIM

TO BE FILED WITH THE DISTRICT DIRECTOR WHERE ASSESSMENT WAS MADE OR TAX PAID

District Director's Stamp (Date Received)

RECEIVED
APR 21 1969
DIRECTOR INT REV
ST. LOUIS
TELLER - #1

The District Director will indicate in the block below the kind of claim filed, and fill in, where required.

- ☐ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
- ☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- ☐ Abatement of Tax Assessed (not applicable to estate, gift, or income taxes).

PLEASE TYPE OR PRINT PLAINLY

Name of taxpayer or purchaser of stamps
ITT Hamilton Life Insurance Company

Number and street
212 South Central Avenue

City, town, State, Postal ZIP Code
St. Louis, Missouri 63105

Fill in applicable items—Attach letter size sheets if space is not sufficient

a. Your social security number | Wife's number, if joint return | b. If an employer, enter employer identification number
43-0713325

c. District in which return (if any) was filed
St. Louis, Missouri

d. Name and address shown on return, if different from above
American Universal Life Insurance Company
111 South Meramec, Clayton, Missouri 63105

e. Period—If for tax reported on annual basis, prepare separate form for each taxable year
From January 1, 19 64, to December 31, 19 64

f. Kind of tax
Income

g. Amount of assessment
$ 448,526.63

Dates of payment
March 5, 1969

h. Date stamps were purchased from Government

i. Amount to be refunded (if income tax, complete computation below)
$ 448,526.63 *#

j. Amount to be abated (not applicable to income, estate, or gift taxes)
$

k. The claimant believes that this claim should be allowed for the following reasons:

See statement attached.

*plus $140,482.78 per claim filed August 18, 1967, or such greater amount as may be legally refundable, with statutory interest

COMPUTATION OF INCOME TAX REFUND	Income Tax
1. Tax withheld	0
2. Estimated tax paid	355,430.00
3. Tax paid with original return	21,787.70
# 4. Any additional income tax paid including $85,540.43 assessed interest	448,526.63
5. Total tax paid (Add lines 1-4)	825,744.33
6. Less: Your computation of correct tax	236,734.92
7. Amount of overpayment	589,009.41
8. Amount [illegible] to be refunded per claim filed 8/18/67	140,482.78
9. Net overpayment (Enter in item i above) claimed herein	448,526.63

Under penalties of perjury, I declare that this claim, including any accompanying schedules and statements, has been examined by me and to the best of my knowledge and belief it is true and correct.

Signed ITT HAMILTON LIFE INSURANCE COMPANY

Dated April 18, 19 69 By: Joseph Kutten, Chairman of the Board and Chief Executive Officer

SEE INSTRUCTIONS ON REVERSE

FORM 843 (Rev. 7-65)

STATEMENT OF REASONS FOR CLAIM

1. On March 5, 1969, taxpayer paid $448,526.63 to the District Director of Internal Revenue, St. Louis, Missouri, consisting of $362,986.20 in tax, and $85,540.43 in assessed interest, pursuant to notice and demand for payment. Said payment was made under protest on the following grounds, which constitute the first reason for this claim for refund:

On August 18, 1967, taxpayer filed a claim for refund of $140,482.78 in 1964 income taxes. No action having been taken by the Secretary or his delegate to allow or disallow said claim, taxpayer on April 4, 1968, filed suit for refund in the United States Court of Claims. Said suit is now pending, No. 109–68.

On October 24, 1968, at a time when said suit for refund was pending, the Commissioner of Internal Revenue mailed to taxpayer a statutory notice of deficiencies, including a deficiency in income tax for the year 1964 in the amount of $362,986.20. After the lapse of more than 90 days from and after October 24, 1968, the Commissioner purported to assess said deficiency, notice of said alleged assessment was given and demand for payment thereof was made.

Section 7422(e), Internal Revenue Code of 1954, provides in material part as follows:

> "If the Secretary or his delegate prior to the hearing of a suit brought by a taxpayer in * * * the Court of Claims for the recovery of any income tax * * * mails to the taxpayer a notice that a deficiency has been determined in respect of the tax which is the subject matter of taxpayer's suit, the proceedings in taxpayer's suit shall be stayed during the period of time in which the taxpayer may file a petition with the Tax Court for a redetermination of the asserted deficiency, and for 60 days thereafter. * * * If the taxpayer does not file a petition with the Tax Court for a redetermination of the asserted deficiency, the United States may counterclaim in the taxpayer's suit * * * within the period of the stay of proceedings * * *."

As applied to this case, this means that the proceedings in taxpayer's Court of Claims Suit No. 109–68 were stayed until March 23, 1969, and the United States might have counterclaimed for the aforementioned asserted deficiency at any time after January 22 and on or prior to March 23, 1969. It did not do so.

Taypayer contends, therefore, that said alleged assessment of deficiency pursuant to notice and demand for payment of which taxpayer, on March 5, 1968, paid under protest the said sum of $448,526.63, is illegal and void, the sole legal means of collection of said asserted deficiency having been by counterclaim in said Court of Claims suit, as provided in Section 7422(e).

2. Secondly, the Commissioner erred in determining said deficiency of $362,986.20, of which notice was given October 24, 1968. Said determination is predicated upon the holding that taxpayer for its taxable year ended December 31, 1964, did not qualify as a life insurance company within the meaning of Section 801 of the Internal Revenue Code of 1954, but was taxable under Sections 831 and 832 as an insurance company other than a life or mutual insurance company. Taxpayer contends that it did qualify as a life insurance company under the statutory test and is therefore taxable as such for the year 1964.

214-447—76——3

Exhibit F

FORM 843 (Rev. July 1968)

U.S. TREASURY DEPARTMENT - INTERNAL REVENUE SERVICE

CLAIM

TO BE FILED WITH THE DISTRICT DIRECTOR WHERE ASSESSMENT WAS MADE OR TAX PAID.

Internal Revenue Service Stamp (date received)

RECEIVED
APR 21 1969
DIRECTOR INT REV
ST. LOUIS
TELLER - 52

The District Director will indicate in the block below the kind of claim filed, and list no. where required.

- ☐ Refund of Taxes Illegally, Erroneously, or Excessively Collected.
- ☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- ☐ Abatement of Tax Assessed (not applicable to estate, gift, or income taxes).

PLEASE TYPE OR PRINT PLAINLY

43

Name of taxpayer or purchaser of stamps
ITT Hamilton Life Insurance Company

Number and street
212 South Central Avenue

City, town, State, Postal ZIP Code
St. Louis, Missouri 63105

Fill in applicable items—Attach letter size sheets if space is not sufficient

a. Your social security number | b. Claim number (if known) | c. Employer identification number
43-0712320

d. District in which return (if any) was filed
St. Louis, Missouri

d. Name and address shown on return, if different from above
American Universal Life Insurance Company
111 South Meramec, Clayton, Missouri 63105

e. Period—if tax reported on annual basis, prepare separate form for each taxable year
From January 1 1965 To December 31 1965

f. Kind of tax
Income

g. Amount of assessment
$ 312,033.68

Dates of payment
March 5, 1969

h. Date stamps were purchased from Government

i. Amount to be refunded (if income tax, complete computation below)
$ 312,033.68 *#

j. Amount to be abated (not applicable to income, estate, or gift taxes)
$

k. The claimant believes that this claim should be allowed for the following reasons:

See statement attached.

*plus $47,252.76 per claim filed August 18, 1967, or such greater amount as may be legally refundable, with statutory interest

COMPUTATION OF INCOME TAX REFUND	Income Tax
1. Tax withheld	0
2. Estimated tax paid	232,000.00
3. Tax paid with original return	235,200.14
# 4. Any additional income tax paid including $76,621.63 assessed interest	312,033.95
5. Total tax paid (Add lines 1-4)	779,234.09
6. Less: Your computation of correct tax	420,013.38
7. Amount of overpayment	359,220.71
8. Amount to be refunded per claim filed 8/18/67	47,252.76
9. Net overpayment (Enter in item i above) claimed herein	312,033.68

Under penalties of perjury, I declare that this claim, including any accompanying schedules and statements, has been examined by me and to the best of my knowledge and belief it is true and correct.

Signed ITT HAMILTON LIFE INSURANCE COMPANY
CHAIRMAN OF THE BOARD AND
Dated APRIL 8, 1969 By: JOSEPH KUTTEN CHIEF EXECUTIVE OFFICER

SEE INSTRUCTIONS ON REVERSE

FORM 843 (Rev. 7-68)

STATEMENT OF REASONS FOR CLAIM

1. On March 5, 1969, taxpayer paid $312,033.68 to the District Director of Internal Revenue, St. Louis, Missouri,

consisting of $265,412.05 in tax, and $46,621.63 in assessed interest, pursuant to notice and demand for payment. Said payment was made under protest on the following grounds, which constitute the first reason for this claim for refund.

On August 18, 1967, taxpayer filed a claim for refund of $47,252.76 in 1965 income taxes. No action having been taken by the Secretary or his delegate to allow or disallow said claim, taxpayer on April 4, 1968, filed suit for refund in the United States Court of Claims. Said suit is now pending, No. 109-68.

On October 24, 1968, at a time when said suit for refund was pending, the Commissioner of Internal Revenue mailed to taxpayer a statutory notice of deficiencies, including a deficiency in income tax for the year 1965 in the amount of $265,412.05. After the lapse of more than 90 days from and after October 24, 1968, the Commissioner purported to assess said deficiency, notice of said alleged assessment was given and demand for payment thereof was made.

Section 7422(e), Internal Revenue Code of 1954, provides in material part as follows:

> "If the Secretary or his delegate prior to the hearing of a suit brought by a taxpayer in * * * the Court of Claims for the recovery of any income tax * * * mails to the taxpayer a notice that a deficiency has been determined in respect of the tax which is the subject matter of taxpayer's suit, the proceedings in taxpayer's suit shall be stayed during the period of time in which the taxpayer may file a petition with the Tax Court for a redetermination of the asserted deficiency, and for 60 days thereafter. * * * If the taxpayer does not file a petition with the Tax Court for a redetermination of the asserted deficiency, the United States may counterclaim in the taxpayer's suit * * * within the period of the stay of proceeding * * * ."

As applied to this case, this means that the proceedings in taxpayer's Court of Claims Suit No. 109-68 were stayed until March 23, 1969, and the United States might have counterclaimed for the aforementioned asserted deficiency at any time after January 22 and on or prior to March 23, 1969. It did not do so.

Taxpayer contends, therefore, that said alleged assessment of deficiency pursuant to notice and demand for payment of which taxpayer on March 5, 1968, paid under protest the said sum of $312,033.68, is illegal and void, the sole legal means of collection of said asserted deficiency having been by counterclaim in said Court of Claims suit, as provided in Section 7422(e).

2. Secondly, the Commissioner erred in determining said deficiency of $265,412.05, of which notice was given October 24, 1968. Said determination is predicated upon the holding that taxpayer for its taxable year ended December 31, 1965, did not qualify as a life insurance company within the meaning of Section 801 of the Internal Revenue Code of 1954, but was taxable under Sections 831 and 832 as an insurance company other than a life or mutual insurance company. Taxpayer contends that it did qualify as a life insurance company under the statutory test, and is therefore taxable as such for the year 1965.

Answer to First Amended Petition

(Number and title omitted.)

(Filed: April 29, 1970)

Defendant, the United States of America, in answer to the First Amended Petition filed in the above-entitled action, denies each and every allegation contained therein, not admitted, qualified, or expressly referred to below:

Defendant further:

COUNT I

1. Admits paragraph 1, but denies that income taxes, the recovery of which is claimed by plaintiff, were overpaid for the calendar year 1963.

2. Admits the allegations contained in paragraph 2.

3. States that it is presently unable to obtain knowledge or information sufficient to form a belief concerning the truth of the allegations contained in paragraph 3.

4. Denies the allegations contained in paragraph 4.

5. Denies the allegations contained in paragraph 5.

6. Denies the allegations contained in paragraph 6.

7. Admits the allegations contained in paragraph 7.

8. Denies the allegations contained in paragraph 8.

9. Admits the allegations contained in paragraph 9, but denies that income taxes the recovery of which is claimed by the plaintiff constituted an overpayment of income tax for the year 1963.

10. Admits the allegations contained in paragraph 10.

11. Admits the allegations contained in paragraph 11.

12. Admits the allegations contained in paragraph 12.

13. Denies the allegations contained in paragraph 13, and further alleges that—

(a) defendant filed a counterclaim which was incorporated in an Amended Answer filed on April 25, 1969,

(b) the counterclaim was filed within the time provided therefor in Section 7422(e) of the Code,

(c) plaintiff filed a Reply To Counterclaim on August 14, 1969, in which it alleged that the amount claimed in the defendant's counterclaim had previously been paid by the plaintiff,

(d) since the plaintiff has paid the taxes for which the counterclaim was filed and amended its petition to include a claim for refund of these taxes, a counterclaim by the defendant is no longer necessary, nor required by law.

14. Admits the allegations contained in paragraph 14, and alleges further that an assessment was, in fact, made on February 14, 1969.

15. Denies the allegations contained in paragraph 15.

16. Admits the allegations contained in paragraph 16.

17. Admits the allegations contained in paragraph 17, but denies that income taxes the recovery of which is claimed by plaintiff constituted an overpayment of income tax for the calendar year 1963.

18. Admits the allegations contained in paragraph 18.

COUNT II

1. Admits the allegations contained in paragraph 1, but denies that income taxes the recovery of which is claimed by plaintiff were overpaid for the calendar year 1963.

2. Admits the allegations contained in paragraph 2.

3. States that it is presently unable to obtain knowledge or information sufficient to form a belief concerning the truth of the allegations contained in paragraph 3.

4. Admits the allegations contained in paragraph 4.

5. States that it is presently unable to obtain knowledge or information sufficient to form a belief concerning the truth of the allegations contained in paragraph 5.

6. Admits the allegations contained in paragraph 6.

7. Admits the allegations contained in paragraph 7, but denies that income taxes the recovery of which is claimed by plaintiff constituted an overpayment of income tax for the calendar year 1963.

8. Admits the allegations contained in paragraph 8.

9. Admits the allegations contained in paragraph 9.

10. Admits the allegations contained in paragraph 10.

11. Denies the allegations contained in paragraph 11, and further alleges that—

(a) defendant filed a counterclaim which was incorporated in an Amended Answer filed on April 25, 1969,

(b) the counterclaim was filed within the time provided therefor in Section 7422(e) of the Code,

(c) plaintiff filed a Reply To Counterclaim on August 14, 1969, in which it alleged that the amount claimed in the defendant's counterclaim had previously been paid by the plaintiff,

(d) since the plaintiff has paid the taxes for which the counterclaim was filed and amended its petition to include a claim for refund of these taxes, a counterclaim by the defendant is no longer necessary, nor required by law.

12. Admits the allegations contained in paragraph 12, and alleges further that an assessment was, in fact, made on February 14, 1969.

13. Denies the allegations contained in paragraph 13.

14. Admits the allegations contained in paragraph 14.

15. Admits the allegations contained in paragraph 15, but denies that amounts of income tax the recovery of which is claimed by plaintiff constituted an overpayment of income tax for the calendar year 1963.

16. Admits the allegations contained in paragraph 16.

COUNT III

1. Admits paragraph 1, but denies that income taxes the recovery of which is claimed by plaintiff were overpaid for the calendar year 1964.

2. Admits the allegations contained in paragraph 2.

3. States that it is presently unable to obtain knowledge or information sufficient to form a belief concerning the truth of the allegations contained in paragraph 3.

4. Denies the allegations contained in paragraph 4.

5. Denies the allegations contained in paragraph 5.

6. Denies the allegations contained in paragraph 6.

7. Admits the allegations contained in paragrah 7.

8. Denies the allegations contained in paragraph 8.

9. Admits the allegations contained in paragraph 9.

10. Admits the allegations contained in paragraph 10.

11. Admits the allegations contained in paragraph 11.

12. Admits the allegations contained in paragraph 12.

13. Denies the allegations contained in paragraph 13, and further alleges that—

(a) defendant filed a counterclaim which was incorporated in an Amended Answer filed on April 25, 1969,

(b) the counterclaim was filed within the time provided therefor in Section 7422(e) of the Code,

(c) plaintiff filed a Reply To Counterclaim on August 14, 1969, in which it alleged that the amount claimed in the defendant's counterclaim had previously been paid by the plaintiff,

(d) since the plaintiff has paid the taxes for which the counterclaim was filed and amended its petition to include a claim for refund of these taxes, a counterclaim by the defendant is no longer necessary, nor required by law.

14. Admits the allegations contained in paragraph 14, and alleges further that an assessment was, in fact, made on February 14, 1969.

15. Denies the allegations contained in paragraph 15.

16. Admits the allegations contained in paragraph 16.

17. Admits the allegations contained in paragraph 17, but denies that income taxes the recovery of which is claimed

by plaintiff constituted an overpayment of income tax for the calendar year 1964.

18. Admits the allegations contained in paragraph 18.

COUNT IV

1. Admits paragraph 1, but denies that income taxes the recovery of which is claimed by plaintiff were overpaid for the calendar year 1965.

2. Admits the allegations contained in paragraph 2.

3. States that it is presently unable to obtain knowledge or information sufficient to form a belief concerning the truth of the allegations contained in paragraph 3.

4. Denies the allegations contained in paragraph 4.

5. Denies the allegations contained in paragraph 5.

6. Denies the allegations contained in paragraph 6.

7. Admits the allegations contained in paragraph 7.

8. Denies the allegations contained in paragraph 8.

9. Admits the allegations contained in paragraph 9, but denies that income taxes the recovery of which is claimed by the plaintiff constituted an overpayment of income tax for the calendar year 1965.

10. Admits the allegations contained in paragraph 10.

11. Admits the allegations contained in paragraph 11.

12. Admits the allegations contained in paragraph 12.

13. Denies the allegations contained in paragraph 13, and further alleges that—

(a) defendant filed a counterclaim which was incorporated in an Amended Answer filed on April 25, 1969,

(b) the counterclaim was filed within the time provided therefor in Section 7422(e) of the Code,

(c) plaintiff filed a Reply To Counterclaim on August 14, 1969, in which it alleged that the amount claimed in the defendant's counterclaim had previously been paid by the plaintiff,

(d) since the plaintiff has paid the taxes for which the counterclaim was filed and amended its petition to include a claim for refund of these taxes, a counterclaim by the defendant is no longer necessary, nor required by law.

14. Admits the allegations contained in paragraph 14, and alleges further that an assessment was, in fact, made on February 14, 1969.

15. Denies the allegations contained in paragraph 15.

16. Admits the allegations contained in paragraph 16.

17. Admits the allegations contained in paragraph 17, but denies that income taxes the recovery of which is claimed by plaintiff constituted an overpayment of income tax for the calendar year 1965.

18. Admits the allegations contained in paragraph 18.

WHEREFORE, defendant prays that the petition be dismissed with cost assessed against plaintiff.

Respectfully submitted,

JOHNNIE M. WALTERS,
Assistant Attorney General.

ROGER A. SCHWARZ,
Attorney.

Stipulation of Fact

(Number and title omitted.)

(Filed: August 6, 1971)

It is hereby stipulated that,, for the purpose of this case, the following statements may be accepted as facts and all exhibits referred to herein and attached hereto are incorporated in this stipulation and made a part hereof, subject to the right of either party to object to the admission of such statements or exhibits in evidence on the grounds of materiality or relevancy.

I. Plaintiff was incorporated on August 8, 1955, under the statutes of the State of Missouri applicable to the organization of life insurance companies. Amended Articles of Incorporation were filed on September 6, 1957. During the years 1963, 1964 and 1965, and at all other relevant times, it was empowered by its Articles of Incorporation and authorized by the insurance authorities of the State of Missouri to engage in the business of insuring and reinsuring

life and health and accident insurance contracts and has carried on such business exclusively.

2. Aetna Finance Company (Aetna) was incorporated in 1924 under the laws of the State of Missouri. Plaintiff became a wholly-owned subsidiary of Aetna in 1959. Prior to 1959, Plaintiff's stock was owned by Richard Yalem and Carolyn Kutten, the son and daughter of Charles H. Yalem, the principal stockholder of Aetna. Some Aetna stock was also held beneficially for Richard and Carolyn in trusts created by Charles H. Yalem.

3. All of Aetna's assets, including the capital stock of Plaintiff and other subsidiary corporations of Aetna, were acquired by International Telephone and Telegraph Corporation (IT&T) on August 31, 1964, and Aetna was subsequently dissolved. IT&T transferred Aetna's assets to ITT Aetna Corporation, an IT&T subsidiary, as a contribution to capital. In 1966, ITT Aetna's stock was transferred to ITT Consumer Services Corporation, another subsidiary of IT&T. (References made hereafter to "Aetna" refer to Aetna Finance Company for the period on or before August 31, 1964, and to ITT Aetna Corporation for the period after August 31, 1964, where appropriate.)

4. Plaintiff was originally incorporated under the name American Universal Life Insurance Company, and operated under this name during the years in issue. Its name was changed to ITT Life Insurance Company in 1966 and to ITT Hamilton Life Insurance Company in 1967. The final change in name reflected the combination of Plaintiff's operations with those of the Alexander Hamilton Life Insurance Company, a former IT&T subsidiary which became a subsidiary of Plaintiff in 1966 and was merged into Plaintiff in 1967.

5. Until approximately 1966, Plaintiff's principal business consisted of reinsuring certain insurance companies with respect to credit insurance policies issued by those companies insuring the lives and health of loan customers of Aetna and its finance company subsidiaries. During the years in issue, operating subsidiaries of Aetna had over 200 offices in approximately 25 states engaged in the business of making consumer loans.

6. Credit life insurance, generally defined, is term insurance on the lives of debtors, with their creditors as bene-

ficiaries, in amounts at least sufficient to discharge their indebtedness in case of death. Sometimes the life coverage is combined with the accident and health coverage. Such coverage pays the debtor's monthly installments during the period within the policy term in which he is totally disabled (*i.e.*, unable to work) because of accident or sickness, provided that the disability lasts beyond a minimum or "waiting" period. Sometimes coverage is conditioned upon the permanent as well as total disability of the debtor.

7. Credit life and accident and health insurance is sold usually as a part of another, and more prominent transaction, namely, a loan of money or an installment sale of tangible personal property. Its primary function is to provide a sure, quick, and uncomplicated means for liquidating the balance due on the loan or installment sale in the event of the death of the borrower or purchaser and, where additional health and accident coverage is provided, to pay the borrower's monthly installments while he is unable to work.

8. Credit life and accident and health insurance is written in two different ways: (1) under an individual insurance policy issued directly to the insured debtor, or (2) under a group policy, in which case the beneficiary-creditor is the policy holder and the individual insured debtor simply receives a certificate of insurance. It is generally written for a term which is coextensive with the contractual term of the related indebtedness. Occasionally a company may write a policy with a term of as long as five years, but the average in the industry is two to three years in most instances.

9. Two types of life insurance coverage are provided by credit life insurance, namely: (1) decreasing term coverage (also called declining balance insurance), under which the amount of the death benefit decreases during the policy term, coincidentally with the decrease in the amount of the debt under the applicable installment payment schedule, and (2) level term coverage, under which the amount of the death benefit remains constant during the policy term (a type of coverage particularly suitable where the debt is not payable in regular installments, but, for example, in a lump sum). Benefits under additional accident and health coverage are generally computed in the same manner regardless of whether the life insurance coverage is on a

decreasing term or level term basis. In the event of disability occasioned by accident or sickness, the accident and health coverage pays a monthly indemnity determined by dividing the amount of the loan by the number of months in the term. If the disability lasts for less than a full month (but longer than the minimum waiting period), a proportionate part of the monthly indemnity is paid.

10. Under a standard credit life and accident and health insurance policy, the creditor is the primary beneficiary to the extent of the unpaid balance of the indebtedness account at the time of the insured debtor's death or disability caused by accident or sickness. If, because of prepayment or some other reason, the amount of the death benefit payable under the policy should happen to exceed the balance due on the account, the insured's designated secondary beneficiary receives the excess. In the case of accident and health coverage, if the monthly indemnity exceeds the balance due on the account, the excess would usually be paid to the debtor himself.

11. Like some forms of group insurance, but unlike ordinary whole-life or term insurance, a flat rate for credit life insurance and for accident and health coverage is charged, and an inquiry is generally not made as to the age, health, or medical history of the applicant.

12. Essentially, credit life insurance is simply a specialized form of term life insurance written for a specific purpose as described in paragraph 7, *supra*. Unlike insurance such as fire, public liability, and similar types of casualty insurance, credit life insurance contracts, including those reinsured by Plaintiff, cannot be canceled by the insurance company during the term for which they are written. This remains true where additional accident and health coverage is provided in the credit life insurance policy; that is, neither the credit life coverage nor the credit accident and health coverage can be canceled by the insurance company during the term for which the policy is written.

Refunds to debtors allowable under the terms of credit life, accident and health policies, including those reinsured by Plaintiff, are usually calculated in accordance with the Rule of 78 (see paragraph 26, *infra*.)

13. The premium charge for a life insurance contract is computed so as to cover all the contingencies the insurance company is likely to meet, and these contingencies are generally grouped into three elements, namely, mortality, interest, profit and expenses. Mortality refers to that part of the premium which provides for the occurrence of the *risk* insured against, while the second element takes into account the assumed interest to be earned by the company. The third element primarily covers profit and the cost incident to management of the company, such as salaries, rents, commissions, taxes, and other costs of doing business. In arriving at a premium charge, the first and second step is the computation of what is called a "net premium" which takes into account only the mortality and interest elements. To the net premium is then added an amount called "loading" which is calculated to provide for profit and expenses. The resulting premium, called the "gross premium" is the premium charged to the policyholder.

The premium charge for accident and health insurance coverage is computed similarly to a life insurance premium, except that the mortality element of a life insurance premium is replaced by the "morbidity" element of the accident and health premium (*i.e.*, that part of the premium which provides for the occurrence of the *risk* of the insured becoming disabled because of accident or sickness.)

14. During the years 1963, 1964 and 1965, most of the individual and group credit life and combined credit life, accident and health policies covering the lives and health of debtors of Aetna and its subsidiaries were issued by Old Republic Life Insurance Company of Chicago, Illinois ("Old Republic"), Pilot Life Insurance Company of Greensboro, North Carolina ("Pilot") and National Fidelity Life Insurance Company of Kansas City, Missouri ("National Fidelity"). To a much lesser extent, such credit insurance policies were also issued by Insurance City Life Company ("Insurance City") and by American Bankers Life Assurance Company ("American Bankers"). None of the above insurance companies was owned or controlled, directly or indirectly, by Plaintiff, Aetna, or IT&T.

15. Plaintiff entered into "Life Reinsurance Treaty No. 6" with Old Republic on March 23, 1961, effective as of Janu-

ary 1, 1961, which treaty, as amended, was in force during the years in issue. True and correct copies of this Old Republic credit life reinsurance treaty and subsequent amendments thereto are attached hereto as Exhibit 1.

16. Plaintiff entered into a "Disability Reinsurance Treaty" with Old Republic on March 23, 1961, effective as of January 1, 1961, which treaty, as amended, was in force during the years in issue. True and correct copies of this Old Republic disability reinsurance treaty and subsequent amendments thereto are attached hereto as Exhibit 2.

17. Plaintiff entered into a "Credit Life Reinsurance Agreement" with Pilot on July 2, 1957, effective as of February 1, 1957, which agreement, as amended, was in force during the years in issue. True and correct copies of this Pilot credit life reinsurance treaty and subsequent amendments thereto are attached hereto as Exhibit 3.

18. Plaintiff entered into an "Accident and Health Reinsurance Agreement" with Pilot on July 2, 1957, effective as of July 1, 1957, which agreement, as amended, was in force during the years in issue. True and correct copies of this Pilot credit accident and health reinsurance treaty and subsequent amendments thereto are attached hereto as Exhibit 4.

19. Plaintiff entered into a "Credit Life Reinsurance Agreement" with National Fidelity on July 2, 1957, effective as of February 1, 1957, which agreement, as amended, was in force during the years in issue. True and correct copies of this National Fidelity credit life reinsurance treaty and subsequent amendments thereto are attached hereto as Exhibit 5.

20. Plaintiff entered into an "Accident and Health Reinsurance Agreement" with National Fidelity on July 2, 1957, effective as of July 1, 1957, which agreement, as amended, was in force during the years in issue. True and correct copies of this National Fidelity credit accident and health reinsurance treaty and subsequent amendments thereto are attached hereto as Exhibit 6.

21. Plaintiff entered into a "Reinsurance Agreement" with Insurance City on August 24, 1962, effective as of July 1, 1962, which agreement was in force during the years in issue. A true and correct copy of this Insurance City reinsurance treaty is attached hereto as Exhibit 7.

22. Plaintiff entered into a "Reinsurance Agreement" with American Bankers on October 23, 1959, effective as of Octo-

ber 1, 1959, which agreement was in force during the years in issue. A true and correct copy of this American Bankers reinsurance treaty is attached hereto as Exhibit 8.

23. Plaintiff entered into a separate "Reinsurance Agreement" with Pilot for certain insurance issued by Pilot in North Carolina on March 23, 1962, effective as of April 1, 1962, which agreement was in force during the years in issue. A true and correct copy of this Pilot "North Carolina" reinsurance treaty is attached hereto as Exhibit 9.

24. The policies covered by the above reinsurance treaties provided either credit life insurance only or credit life and credit accident and health coverage combined in a single policy with the same maximum amount of insurance under both coverages (*i.e.*, the amount of the loan). None of the policies provided only credit accident and health coverage (without credit life coverage) with the exception of National Fidelity Policy Form P–825–12–52, which was issued solely in the State of Oklahoma and was always issued in connection with National Fidelity Policy Form P–727–1253 which provided credit life coverage in a corresponding amount. The combined credit life, accident and health policies disclosed separate single premiums for credit life coverage and credit accident and health coverage, and, in the case of policies issued by Old Republic, Pilot and National Fidelity, such coverages were reinsured with Plaintiff under separate reinsurance treaties (except for the treaty reinsuring policies issued by Pilot in North Carolina, which included both credit life and credit accident and health coverages) as described above. All of the policies reinsured under the above reinsurance treaties during the years in issue provided for the payment of a single premium at the inception of the insurance coverage. Attached hereto and marked Exhibits 10 to 16 are typical individual and group credit life and credit life, accident and health certificates and policies issued by Old Republic, Pilot, National Fidelity and Insurance City during the years in issue and reinsured by Plaintiff under the above reinsurance treaties.

25. When a credit accident and health premium under a single premium policy is first paid by the insured, it is wholly "unearned," in the sense that the entire premium is attributable to the unexpired portion of the policy. As the term of the policy expires with the passage of time, a pro-

portionate part of the premium becomes "earned"; *i.e.*, attributable to insurance protection provided during the expired portion of the policy.

26. The allocable amount of premiums remaining unearned on the insurer's statement date is usually computed on either a pro rata basis or under the "sum-of-the-digits" method, the latter method being referred to in the insurance industry as the "Rule of 78."[1] For example, an insurance company that received a $300 premium at the inception of a three-year single premium accident and health policy would have an unearned premium reserve at the end of the first year of $200 ($2/3 \times \$300$) computed on a pro rata basis, or an unearned premium reserve of $150.

$$\left(\frac{3}{(3+2+1)} \times \$300\right)$$

computed under the Rule of 78. The unearned premium reserves maintained by Old Republic, Pilot and National Fidelity on credit accident and health insurance covering debtors of Aetna and its subsidiaries, and unearned premium reserves maintained by Plaintiff under its reinsurance treaty with Insurance City, were determined under the Rule of 78.

27. Several methods can be used to arrive at a value for the unearned premium reserve where many policies are outstanding at the statement date. The most precise would be to determine the exact date of issuance of each outstanding policy so that the unexpired portion of each policy in force at the statement date can be ascertained. However, the cost and time involved in making such a computation is prohibitive to companies without sophisticated data processing

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[1] Under the Rule of 78, the unearned premium is determined by applying changing fractions to the premium paid by the insured. The numerator of the fraction changes each year to a number which corresponds to the remaining unexpired term of the policy, and the denominator which remains constant is the sum of all the years' digits corresponding to the entire term of insurance coverage. Where the unearned premium is determined on a monthly rather than a yearly basis, the numerator will correspond to the number of months in the term which remain unexpired and the denominator will be the sum of all the months' digits corresponding to the entire term.

equipment. Therefore, assumptions are commonly made as to the dates on which outstanding policies were issued.

The unearned premium reserves maintained by Old Republic, Pilot, and National Fidelity on credit accident and health insurance covering debtors of Aetna and its subsidiaries, as well as the unearned premium reserves maintained by Plaintiff under its reinsurance treaty with Insurance City, were computed monthly on the assumption that all policies issued during a particular month were issued at the end of the month. For example, if Old Republic received $100,000 in accident and health premiums during the month of December with respect to the issuance of credit life, accident and health policies to Aetna loan customers, its unearned premium reserves were computed on the assumption that all of such policies were issued on December 31 and that the $100,000 in premiums were likewise received on December 31. The Internal Revenue Service has recomputed such unearned premium reserves maintained by Old Republic, Pilot, National Fidelity and Plaintiff at December 31, 1962, 1963, 1964 and 1965, using an assumption that all policies issued during a given month were issued on the 15th day rather than the last day of such month. Plaintiff does not contest such adjustments.

28. The life insurance reserves set aside by Plaintiff during the years in issue were computed by the firm of Nelson and Warren, Inc., independent actuarial consultants, in accordance with the terms of the outstanding reinsured policies and the laws of the State of Missouri based on the Commissioners' 1941 Standard Ordinary Mortality Table and an assumed rate of interest of two percent. The Commissioners' 1941 Standard Ordinary Mortality Table is a recognized mortality table, approved by the National Association of Insurance Commissioners.

29. With respect to all life insurance reserves established and reported by Plaintiff on its Annual Statements, the company which issued the policies in each instance was given credit, as reinsurance ceded, by the insurance authorities of the states in which such companies did business, for the life insurance reserves so established and reported by Plaintiff, to the extent of such State's reserve requirements.

30. For each of the years 1962, 1963, 1964 and 1965, Plaintiff filed an Annual Statement on the form prescribed by the National Association of Insurance Commissioners for life and accident and health companies. The data and statements contained in these Annual Statements were taken from and accurately reflected Plaintiff's books and records. True and correct copies of the Annual Statements filed by Plaintiff for the years 1962, 1963, 1964 and 1965 are attached hereto and marked Exhibits 17 to 20, respectively.

31. Plaintiff did not reflect on its Annual Statements submitted to the Missouri Division of Insurance any unearned premium reserves during 1962, 1963, 1964 or 1965 with respect to credit accident and health insurance issued by Old Republic, Pilot or National Fidelity. Unearned premium reserves on credit accident and health insurance issued by Old Republic, Pilot and National Fidelity covering debtors or Aetna and its subsidiaries were reflected in the Annual Statements filed by Old Republic, Pilot and National Fidelity for the years 1962, 1963, 1964 and 1965 with the insurance authorities of the various states in which they did business. The Annual Statements of those companies were accepted by such authorities in all such states.

32. The only unearned premium reserves reflected on Plaintiff's Annual Statements submitted to the Missouri Division of Insurance for the years 1962, 1963, 1964 and 1965 were those relating to Plaintiff's reinsurance treaty with Insurance City, which were reflected on a gross unearned premium basis.

33. True and correct copies of reports of examination of Plaintiff as of December 31, 1964 and 1968 are attached hereto as Exhibits 24 and 25.

34. Unpaid losses represent the measure of an insurance company's liability to make future payments with respect to claims that have already been incurred as of the statement date. A provision for unpaid losses is needed to cover claims that commenced in the past and under which benefits are still being paid or are to be paid as soon as proof of loss has been provided to the insurer.

35. The Annual Statements filed by Plaintiff with the Missouri Division of Insurance for the years 1962, 1963, 1964 and 1965 reflected unpaid losses with respect to credit accident and health insurance issued by Pilot, National Fide-

lity, Insurance City and American Bankers and reinsured by Plaintiff, and the company which issued the policies in each instance was given credit by the insurance authorities of the states in which such companies did business for unpaid losses reported by Plaintiff. Unpaid losses with respect to credit accident and health insurance issued by Old Republic were reflected on the Annual Statements filed by Old Republic.

36. Some accident and health policies are written for the life of the insured at a guaranteed annual premium. A reserve in addition to the unearned premium reserve must be maintained on such policies as a consequence of charging a premium for a benefit that costs increasingly more to provide as the insured grows older. This additional reserve is accumulated from premium payments and interest earnings that will not be needed to pay claims arising during the current policy year of the contract. The reserve is computed on the basis of recognized morbidity tables at an assumed rate of interest. An additional reserve is also required where the policy is written for some term which is shorter than the insured's life where the premium charged provides a benefit that costs increasingly more to provide as the insured grows older. Neither Old Republic, Pilot, nor National Fidelity maintained an additional reserve in addition to the unearned premium reserve with respect to credit accident and health insurance covering debtors of Aetna and its subsidiaries.

37. Old Republic, Pilot and National Fidelity reflected on their books and Annual Statements unearned gross premium reserves on all credit accident and health insurance reinsured with Plaintiff.

38. Old Republic, Pilot and National Fidelity used and had custody of unearned premiums received for credit accident and health insurance covering debtors of Aetna and its subsidiaries. Such unearned premiums were maintained by Old Republic, Pilot and National Fidelity along with their other reserve funds in accordance with the applicable restrictions of state law, and they received the proceeds of such investments (interests, dividends, etc.) as their own income. Plaintiff did not obtain or use the unearned premiums held by Old Republic, Pilot and National Fidelity before they were payable as reinsurance premimus under the

terms of the respective reinsurance treaties nor were such unearned premiums credited, set apart or made available to Plaintiff.

39. [Deleted]

40. The insurance business is regulated by the states. For example, the state insurance departments supervise policy forms, agency relationships, investments, accounting practices, reserves, and the general financial responsibility of insurance companies. State law and/or regulations directing insurance companies to set up reserves are designed to preserve the solvency of those companies for the protection of policyholders.

41. By 1967, Plaintiff's volume of business had increased to the point at which it was more profitable for Plaintiff to write its own credit insurance policies than to reinsure other companies issuing policies to debtors of Aetna and its subsidiaries.

42. None of the reinsurance treaties in force during the years in issue has even been canceled. When Plaintiff qualified to do business in a state, it notified the company it had been reinsuring that, after a certain date, it would be issuing its own credit insurance policies to loan customers of Aetna in that particular state and that the policies of the former direct insurer would be no longer used. In every case, however, Plaintiff continued to reinsure policies previously issued by the direct insurer (and, in the case of reinsured credit accident and health insurance, the direct insurer continued to pay the reinsurance premiums called for under the terms of the treaty) until all policies that had been reinsured under the treaty had either been terminated, canceled or had expired.

43. Plaintiff today writes a complete portfolio of the standard forms of ordinary and term insurance contracts, including individual and group life, accident and health, and surgical coverage, as well as credit insurance for borrowers and installment purchasers.

44. On December 22, 1965, Plaintiff issued Group Annuity Contract No. 101 to the St. Louis Union Trust Company, as Trustee of Pension Fund No. 6 of the International Telephone Retirement Plan for Salaried Employees, effective as of December 1, 1965. Prior to this transaction, no group

annuity or individual annuity contracts had been purchased by IT&T. The St. Louis Union Trust Company, or any Trustee of any pension fund of the International Telephone Retirement Plan for Salaried Employees from any insurance company or other person on the lives of the individuals covered under Group Annuity Contract No. 101. Group Annuity Contract No. 101 was issued solely by and in the name of Plaintiff, and has remained outstanding and in effect to the present time.

45. A true and correct copy of the International Telephone Retirement Plan for Salaried Employees as amended to July 1, 1966, is attached hereto as Exhibit 21. The terms of the Plan in effect on December 1, 1965, were substantially the same in all relevant respects as the terms contained in Exhibit 21. A true and correct copy of a Trust Agreement between IT&T and the St. Louis Union Trust Company pursuant to ITT's International Telephone Retirement Plan for Salaried Employees, dated as of December 15, 1965, is attached hereto as Exhibit 22. A true and correct copy of Group Annuity Contract No. 101 issued by Plaintiff to the St. Louis Union Trust Company as Trustee of Pension Fund No. 6 of the International Telephone Retirement Plan for Salaried Employees, as amended, is attached hereto as Exhibit 23.

46. On or about December 22, 1965, Plaintiff received securities valued at $5,929,057.24 from the St. Louis Union Trust Company for the purchase of single premium annuities for certain retired individuals covered by the International Telephone Retirement Plan for Salaried Employees. The receipt of such premiums obligated Plaintiff to pay annuities to such retired individuals (and their spouses, in some cases) under the terms of Group Annuity Contract No. 101.

47. Plaintiff maintained a reserve of $6,072,004.00 on December 31, 1965, with respect to its liabilities under Group Annuity Contract No. 101 on that date. Such reserve was computed on the basis of a recognized mortality table (1951 G.A.) and an assumed rate of interest (3½%), and was set aside to mature or liquidate future unaccrued claims arising under Group Annuity Contract No. 101.

48. For each of the years 1963, 1964 and 1965, Plaintiff timely filed with the District Director of Internal Revenue at St. Louis a Federal income tax return on Treasury Form

1120L, U.S. Life Insurance Company tax return, and computed its taxable income and tax as a life insurance company according to section 802 of the Code. The tax shown to be due on the returns filed for those years, as reported in the table below, was paid in full.

Year:	*Tax Shown To Be Due On Plaintiff's Return*
1963	$479,356.02
1964	377,217.70
1965	467,266.14

49. On August 18, 1967, Plaintiff filed with the District Director of Internal Revenue at St. Louis, Missouri, claims for refund of income taxes previously paid in respect of the years 1963, 1964 and 1965 (hereafter referred to as the 1967 claims) in the following amounts:

Year:	*Amount Claimed*
1963	$156,148.50 (or in the alternative $143,737.56).
1964	$140,482.78.
1965	$47,252.76.

50. Neither the Secretary of Treasury or his delegate having theretofore rendered a decision on said 1967 claims, Plaintiff on April 4, 1968, filed suit for a refund of such income taxes in this Court.

51. On October 24, 1968, after Plaintiff had filed a petition claiming a refund of income taxes paid in respect of the years 1963, 1964 and 1965 in this Court, and prior to a hearing of Plaintiff's claims, the Commissioner of Internal Revenue determined deficiencies in Plaintiff's income tax for the years 1963, 1964 and 1965, in the following amounts:

Year:	*Deficiency*
1963	$337,376.70
1964	362,986.20
1965	265,412.05

The asserted deficiencies were based upon a determination that Plaintiff did not qualify as a life insurance company during the years 1963, 1964 and 1965 under section 801(a) of the Code, but rather was taxable as an insurance company other than a life or mutual insurance company in those years.

52. Plaintiff did not file a petition with the Tax Court for a redetermination of the asserted deficiency within the time allowed by section 6213(a) of the Code, or at any

time thereafter. On February 14, 1969, the Commissioner of Internal Revenue assessed the amount of the asserted deficencies in Plaintiff's income tax for the years 1963, 1964 and 1965, together with interest on such deficiencies, and demanded payment thereof. Plaintiff contests the validity of this assessment. On March 5, 1969, the following amounts were paid to the District Director of Internal Revenue at St. Louis, Missouri, under protest, in respect of the deficiencies in Plaintiff's income taxes assessed for the years 1963, 1964 and 1965, and interest thereon:

Year	Deficiency	Interest	Total
1963	$337,376.70	$99,747.96	$437,124.66
1964	362,986.20	85,540.43	448,526.63
1965	265,412.05	46,621.63	312,033.26

53. On April 21, 1969, Plaintiff filed with the District Director of Internal Revenue at St. Louis, Missouri, claims for refund of the amounts assessed by the Commissioner of Internal Revenue on February 14, 1969, and paid by Plaintiff on March 5, 1969, as additional income taxes, and interest thereon, for the years 1963, 1964 and 1965 (hereafter referred to as the 1969 claims). Plaintiff received a formal notice of disallowance of its 1969 claims from said District Director on December 3, 1969, and filed its First Amended Petition with this Court on March 30, 1970, seeking recovery of income taxes with respect to both its 1969 and 1967 claims.

54. On May 8, 1969, Defendant filed a motion with this Court for leave to file an amended answer to Plaintiff's petition. The purpose of the amended answer was to add a counterclaim to defendant's answer. Defendant's motion was allowed and an amended answer was filed on July 8, 1969, which amended answer included a counterclaim for the amounts assessed by the Commissioner of Internal Revenue on February 14, 1969, as additional income taxes and interest for the years 1963, 1964 and 1965. Plaintiff filed a reply to Defendant's counterclaim on August 12, 1969, alleging, *inter alia*, full payment of such additional taxes and interest.

55. The amounts of life insurance reserves, unearned premium reserves, and unpaid losses at the end of each of the years 1962, 1963, 1964 and 1965, as reported by Plaintiff on its tax returns and as adjusted by Defendant, are set forth in the following schedule:

ITT Hamilton Life Insurance Company.—Insurance Reserves at December 31, 1962, per Tax Returns and as Adjusted by Commissioner of Internal Revenue.

	12/31/62		
	Per Return	IRS Adjustments	Per Notice of Deficiency
I. Life Insurance Reserves:			
1. Credit Life Insurance	$556, 923. 00	----------	$556, 923. 00
2. Annuity Reserves			
Total Life Insurance Reserves	556, 923. 00	----------	556, 923. 00
II. Total Reserves:			
1. Life Insurance Reserves	556, 923. 00	----------	556, 923. 00
2. Unpaid Losses on Credit Life	91, 706. 40	$5, 245. 48	96, 951. 88
3. Unearned Premiums on Credit A&H	22, 631. 66	1, 326, 635. 36	1, 349, 267. 02
4. Unpaid Losses on Credit A&H	118, 847. 01	(17, 979. 96)	100, 867. 05
Total Reserves	790, 108. 07	1, 313, 900. 88	2, 104, 008. 95

ITT Hamilton Life Insurance Company.—Insurance Reserves at December 31, 1963, per Tax Returns and as Adjusted by Commissioner of Internal Revenue.

	12/31/63		
	Per Return	IRS Adjustments	Per Notice of Deficiency
I. Life Insurance Reserves:			
1. Credit Life Insurance	$733,027.00	($70,241.77)	$662,785.23
2. Annuity Reserves			
Total Life Insurance Reserves	733,027.00	70,241.77	662,785.23
II. Total Reserves:			
1. Life Insurance Reserves	733,027.00	(70,241.77)	662,785.23
2. Unpaid Losses on Credit Life	126,487.73	6,108.70	132,596.43
3. Unearned Premiums on Credit A&H	37,787.68	1,412,430.88	1,450,218.56
4. Unpaid Losses on Credit A&H	195,616.08	(64,384.15)	131,231.93
Total Reserves	1,092,918.49	1,283,913.66	2,376,832.15

ITT Hamilton Life Insurance Company—Insurance Reserves at December 31, 1964, per Tax Returns and as Adjusted by Commissioner of Internal Revenue

	12/31/64		
	Per Return	IRS Adjustments	Per Notice of Deficiency
I. Life Insurance Reserves:			
1. Credit Life Insurance	$806, 698. 00	($58, 076. 72)	$748, 621. 28
2. Annuity Reserves			
Total Life Insurance Reserves	806, 698. 00	(58, 076. 72)	748, 621. 28
II. Total Reserves			
1. Life Insurance Reserves	806, 698. 00	(58, 076. 72)	748, 621. 28
2. Unpaid Losses on Credit Life	309, 061. 73	(7, 491. 63)	301, 570. 10
3. Unearned Premiums on Credit A&H	59, 673. 48	1, 414, 955. 66	1, 474, 629. 14
4. Unpaid Losses on Credit A&H	557, 692. 76	14, 652. 24	572, 345. 00
Total Reserves	1, 733, 125. 97	1, 364, 039. 55	3, 097, 165. 52

ITT Hamilton Life Insurance Company— Insurance Reserves at December 31, 1965, per Tax Returns and as Adjusted by Commissioner of Internal Revenue

	12/31/65		
	Per Return	IRS Adjustments	Per Notice of Deficiency
I. Life Insurance Reserves:			
1. Credit Life Insurance	$965, 229. 00	($63, 226. 31)	$902, 002. 69
2. Annuity Reserves	6, 072, 004. 00	(5, 633, 073. 88)	502, 156. 43
Total Life Insurance Reserves	7, 037, 233. 00	(5, 633, 073. 88)	1, 404, 159. 12
II. Total Reserves:			
1. Life Insurence Reserves	7, 037, 233. 00	(5, 633, 073. 88)	1, 404, 159. 12
2. Unpaid Losses on Credit Life	94, 770. 07	(4, 888. 17)	89, 881. 90
3. Unearned Premiums on Credit A&H	92, 353. 42	1, 738, 805. 49	1, 831, 158. 91
4. Unpaid Losses on Credit A&H	188, 752. 09	(85, 356. 54)	103, 395. 55
Total Reserves	7, 413, 108. 58	(3, 984, 513. 10)	3, 428, 595. 48

56. The amounts of the unearned gross premium reserves maintained by Plaintiff as of December 31, 1962, 1963, 1964 and 1965, and the amounts of the unearned gross premium reserves that Defendant contends are attributable to Plaintiff as of December 31, 1962, 1963, 1964 and 1965, both as adjusted by the Internal Revenue Service as described in paragraph 27 for the purpose of this case, are as follows:

	12/31/62	12/31/63	12/31/64	12/31/65
Plaintiff	$22,631.66	$24,829.73	$34,277.89	$36,593.35
Old Republic	183,841.66	147,374.59	145,823.08	191,415.66
Pilot	728,821.16	782,726.13	724,444.86	829,480.16
National Fidelity	413,972.54	495,288.11	570,083.34	773,669.74
Total	1,349,267.02	1,450,218.56	1,474,629.14	1,831,158.91

57. The adjustments to Plaintiff's unearned premium reserves made by the Internal Revenue Service in determining whether Plaintiff qualified as a life insurance company in the years in issue were calculated on a gross unearned premium basis. Plaintiff contends that the entire amount of such adjustments is improper, but in the alternative contends that unearned premium reserves, particularly those arising from such adjustments, should have been computed on a net premium basis. If the Court sustains Plaintiff's alternative contentions in this regard, and further holds, contrary to Defendant's contention, that Plaintiff's unpaid losses on credit life insurance are includable in the numerator of the life insurance company qualification formula, then Plaintiff will qualify as a life insurance company for each of its taxable years ending December 31, 1963, 1964 and 1965.

The following "tabular morbidity reserves" represent the total "net premium" (*i.e.*, morbidity) element in the unearned gross premium reserves reflected on the Annual Statements of Old Republic, Pilot, National Fidelity and Plaintiff (under the Insurance City reinsurance treaty) on December 31, 1962, 1963, 1964 and 1965, respectively, with

respect to credit accident and health insurance policies issued to loan customers of Aetna and its subsidiaries:

Date:	*Total Tabular Morbidity Reserve*
December 31, 1962	$434,213
December 31, 1963	503,279
December 31, 1964	559,401
December 31, 1965	652,489

The above "tabular morbidity reserves" were computed on the basis of the 1964 Commissioners' Disability Table, a recognized morbidity table approved by the National Association of Insurance Commissioners.

58. The percentage of Plaintiff's "life insurance reserves" to its total reserves (as defined in section 801 of the Internal Revenue Code of 1954) as computed by the Plaintiff on its income tax returns for the years 1963, 1964 and 1965, and as computed by the Defendant on the basis of its adjustments to Plaintiff's reserves were as follows:

	1963, Per Plaintiff's Return		
	1/1/63	12/31/63	Mean
1. Life Insurance Reserves	$556,923.00	$733,027.00	$644,975.00
2. Total Reserves	790,108.07	1,092,918.49	941,513.28
3. Reserve Test Ratio (1÷2)			68.50%
	1963, Per Defendant's Adjustments		
1. Life Insurance Reserves	$556,923.00	$662,785.23	$609,854.12
2. Total Reserves	2,104,008.95	2,376,832.15	2,240,420.55
3. Reserve Test Ratio (1÷2)			27.2%
	1964, Per Plaintiff's Return		
	1/1/64	12/31/64	Mean
1. Life Insurance Reserves	$733,027.00	$806,698.00	$769,862.50
2. Total Reserves	1,092,918.49	1,733,125.97	1,413,022.23
3. Reserve Test Ratio (1÷2)			54.48%

	1964, Per Defendant's Adjustments		
	1/1/64	12/31/64	Mean
1. Life Insurance Reserves	$662, 785. 23	$748, 621. 28	$705, 703. 26
2. Total Reserves	2, 376, 832. 15	3, 097, 165. 52	2, 736, 998. 84
3. Reserve Test Ratio (1÷2)			25. 8%

	1965, Per Plaintiff's Return		
	1/1/65	12/31/65	Mean
1. Life Insurance Reserves	$806, 698. 00	$7, 037, 233. 00	$3, 921, 965. 50
2. Total Reserves	1, 733, 125. 97	7, 413, 108. 58	4, 573, 117. 28
3. Reserve Test Ratio (1÷2)			85. 76%

	1965, Per Defendant's Adjustments		
1. Life Insurance Reserves	$748, 621. 28	$1, 404, 159. 12	$1, 076, 390. 20
2. Total Reserves	3, 097, 165. 52	3, 428, 595. 48	3, 262, 880. 50
3. Reserve Test Ratio (1÷2)			32. 99%

58.59. Added by amendment.

Respectfully submitted,

(S) Owen T. Armstrong,
OWEN T. ARMSTRONG,
Attorney for Plaintiff.

(S) Johnnie M. Walters (PRM)
JOHNNEI M. WALTERS,
Assistant Attorney General.

_____,
Attorney for Defendant.

EXHIBIT 1

LIFE REINSURANCE TREATY

THIS AGREEMENT between OLD REPUBLIC LIFE INSURANCE COMPANY, Clayton, Missouri (herein called "Old Republic") and AMERICAN UNIVERSAL LIFE INSURANCE COMPANF, Clayton, Missouri (herein called "American"),

WITNESSETH:

ARTICLE I

Old Republic hereby agrees to cede to American and American agrees to accept as reinsurance Old Republic's entire liability under all life insurances (herein called "said insurance") written by Old Republic on or after January 1, 1961 under its Account No. 1551, which insures the lives of certain debtors of Aetna Finance Company and its subsidiaries.

ARTICLE II

Old Republic shall pay to American in the manner hereinafter provided, a reinsurance premium equal to ninety one and one quarter percent (91¼%) of the net premium received on said insurances. Net premium, as used in this treaty, shall be gross premium less returns on account of cancellation. Old Republic shall pay all agents' and brokers' commissions and taxes imposed by states on the issuance of said insurances.

ARTICLE III

On the 25th day of February, 1961, and of each month thereafter, Old Republic shall submit to American a statement covering the preceding month and showing the following information with respect to said insurances:

A. Premiums written minus premiums returned to insured persons or policyholders;

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B. Losses incurred (losses and allocated loss expense paid under said insurances during the preceding month, plus loss reserves on said insurances at the end of said month, loss reserves at the beginning of said month);

C. The number of said policies and amount of insurance:

(a) Issued during the preceding month;

(b) Surrendered for cancellation during the preceding month;

(c) Terminated by death during the preceding month;

(d) Expired during the preceding month;

(e) In force at the end of the preceding month.

D. Reinsurance premium;

E. Such other details as may reasonably be requested by American.

Against payment of the reinsurance premium, Old Republic shall be entitled to set off amounts due from American to Old Republic on account of losses and loss expenses paid during said month.

If the reinsurance premium payable exceeds the losses incurred, the excess shall be paid by Old Republic to American at the time said statement is rendered. If the losses incurred exceed the reinsurance premium, the excess shall be paid by American to Old Republic within ten (10) days after receipt of said statement.

ARTICLE IV

Old Republic furnishes American herewith specimen forms upon which all said insurances are written, and will promptly notify American of all changes in said forms. The supervision of all claims under said insurances shall be handled by Old Republic. The liability of American shall follow the liability of Old Republic in accordance with the terms and conditions of said insurances.

ARTICLE V

In the event of the insolvency of Old Republic, the reinsurance under this treaty shall be payable by American on the basis of the claim or claims allowed against the insolvent Old Republic by any court of competent jurisdiction or any justice or judge thereof, or by any receiver or liquidator having authority to determine and allow such claims. It is agreed, however, that the liquidator, receiver or statutory

successor of Old Republic will be required to give written notice to American of the pendency of a claim against Old Republic on the policy reinsured within a reasonable time after such claim is filed, and that during the pendency period of such claim, American may investigate such claim and interpose, at its own expense, in the proceeding where such claim is to be adjudicated, any defense or defenses which it may deem available to Old Republic or its liquidator or receiver or statutory successor. The expense thus incurred by American shall be chargeable, subject to court approval, against Old Republic as part of the expense of liquidation to the extent of a proportionate share of the benefit which may accrue to Old Republic solely as a result of the defense undertaken by American.

ARTICLE VI

In the event of the insolvency, bankruptcy, rehabilitation, receivership or liquidation of American, Old Republic may retain all or any portion of any amount due under this treaty for the purpose of paying any and all losses of policyholders and expenses pertaining thereto which arise or may arise under the insurances reinsured under this treaty. When all losses have been paid, Old Republic shall pay to American the full amount of any balance of the reinsurance premium then remaining.

ARTICLE VII

A. This treaty may, by mutual consent, be altered in any of its terms and conditions by a signed addendum thereto.

B. This treaty may be terminated by either party upon sixty (60) days' written notice to the other party given at any time.

C. Upon termination by either party, this treaty shall continue to apply to all said insurances issued before the date such termination becomes effective and until such insurances expire or are otherwise validly terminated.

ARTICLE VIII

This treaty may be executed in any number of counterparts and all executed counterparts shall be originals.

214-447—76——5

IN WITNESS WHEREOF, the parties hereto have caused this instrument to be duly executed and sealed by their respective corporate seals on this — day of ————, 1961.

OLD REPUBLIC LIFE INSURANCE COMPANY,
By: CHARLES S. WILKES.

Attest:
———— ————, *Secretary.*

AMERICAN UNIVERSAL LIFE INSURANCE COMPANY,
By ———— ————.

Attest:
———— ————, *Secretary.*

ADDENDUM NO. 1 TO REINSURANCE TREATY NO. 6

This Addendum attached to and made a part of a Reinsurance Treaty entered into by OLD REPUBLIC LIFE INSURANCE COMPANY, Chicago, Illinois (therein called "Old Republic" and American Universal Life Insurance Co., Clayton, Missouri, (therein caled "American Universal") on the 23rd of March, 1961.

Witnesseth:

It is hereby agreed between the parties hereto that Article V of the said Reinsurance Treaty is deleted and the following substituted therefor:

"ARTICLE V

In the event of the insolvency of Old Republic, the insurance under this treaty shall be payable without diminution because of Old Republic's insolvency by American Universal to Old Republic's liquidator, receiver or statutory successor on the basis of the claim or claims allowed on said insurances against the insolvent Old Republic by any court of competent jurisdiction or any justice or judge thereof, or by any receiver, liquidator or statutory successor having authority to determine and allow such claims.

It is agreed, however, that the liquidator, receiver or statutory successor of Old Republic shall have to give written notice to American Universal of the pending of a claim against Old Republic on this treaty within a reasonable time after such claim is filed in the insolvency proceeding and that during the pendency of such claim, American Universal may investigate such claim and interpose, at its own expense, in the proceeding where such claim is to be adjudicated any defense or defenses which it may deem available to Old Republic or its liquidator, receiver or statutory successor. The expense thus incurred by American Universal shall be chargeable subject to court approval, against Old Republic as a part of the expense of liquidation to the extent of a proportionate share of the benefits which may accrue to Old Republic solely as a result of the defense undertaken by American Universal."

This Addendum is effective retroactively to the first day of May 1963.

IN WITNESS WHEREOF, the parties have signed this addendum the 7th day of February, 1964.

OLD REPUBLIC LIFE INSURANCE COMPANY,
By CHARLES S. WILKES.
AMERICAN UNIVERSAL LIFE INS. CO.,
By JOSEPH KUTTEN, *President.*

AMENDMENT

TO

LIFE REINSURANCE TREATY No. 6

This Amendment attached to and made a part of a certain Life Reinsurance Treaty No. 6, effective January 1, 1961, between AMERICAN UNIVERSAL LIFE INSURANCE COMPANY, Clayton, Missouri (therein called "American") and OLD REPUBLIC LIFE INSURANCE COMPANY, Chicago, Illinois (therein called "Old Republic"),

Witnesseth:

Old Republic and American hereby agree that the aforesaid Treaty is hereby amended from its inception by the addition of Article IX to read as follows:

> "American will maintain such reserves on this reinsurance as may lawfully be required by regulatory authorities having jurisdiction over American."

All other terms and conditions of said Life Reinsurance Treaty No. 6 remain unchanged and in full force and effect.

IN WITNESS WHEREOF, the parties hereto have caused this Amendment to be executed by their duly authorized officers and their corporate seals affixed this 23rd day of January, 1962.

AMERICAN UNIVERSAL LIFE INSURANCE COMPANY,
By JOSEPH KUTTEN, *Pres.*

Attest:
_____ _____ *Secretary.*

OLD REPUBLIC LIFE INSURANCE COMPANY,
By _____ _____
Vice President.

Attest:
_____ _____ *Secretary.*

EXHIBIT 2

DISABILITY REINSURANCE TREATY

THIS AGREEMENT between OLD REPUBLIC LIFE INSURANCE COMPANY, Chicago, Illinois (herein called "Old Republic") and AMERICAN UNIVERSAL LIFE INSURANCE COMPANY, Clayton, Missouri (herein called "American"),

Witnesseth:

ARTICLE I

A. Old Republic hereby agrees to cede to American and American agrees to accept as reinsurance Old Republic's entire liability under all disability insurances written in combination with life insurance all accident and health insurances

(herein collectively called "said insurances") written by Old Republic on or after January 1, 1961 under its Account No. 1551, which insurances provide coverage for certain debtors of Aetna Finance Company and its subsidiaries.

B. This treaty shall run for a period of one month from the effective date hereof and shall be automatically renewed from month to month until terminated as hereinafter provided.

ARTICLE II

Old Republic shall pay to American in the manner hereinafter provided, a reinsurance premium equal to eighty-nine percent (89%) of the total premiums earned on the said insurances during each month as defined in Article III of this treaty. Old Republic shall pay all agents' and brokers' commissions and taxes imposed by states on the issuance of said insurances.

ARTICLE III

On the 25th day of February, 1961, and each month thereafter, Old Republic shall submit to American a statement covering the preceding month and showing the following information:

A. Earned premiums (premiums written less return premiums plus unearned premium reserves at the beginning of said month less unearned premium reserves at the end of said month, the unearned premium reserves being computed on a monthly pro rata basis);

B. Losses paid, which term includes allocated loss expense. Allocated loss expense shall include all expenses incurred by Old Republic in the investigation, adjustment, litigation and defense of claims including court costs and interest accrued after judgment, but excluding any office expense of Old Republic employees;

C. Loss reserves, including those for incurred but unreported losses, and allocated loss expenses, as of the beginning of the month;

D. Loss reserves, including those for incurred but unreported losses, and allocated loss expenses, as of the end of the month;

E. Amount of accident and health insurance in force at the end of the month;

F. Reinsurance premium.

If the sum of Items B and D is less than the sum of Items C and F shown on said statement, the difference shall be paid by Old Republic to American at the time such statement is delivered. If the sum of Items B and D is more than the sum of Items C and F, the excess is to be paid by American to Old Republic within ten (10) days after the receipt of such statement.

Old Republic shall furnish such details with respect to said monthly statements as may reasonably be requested by American, and American shall have at all times full and free access, during business hours at the home office of Old Republic, to all books, records and files of Old Republic relating to the business covered by this treaty.

ARTICLE IV

Old Republic furnishes American herewith specimen forms upon which all said insurances are written, and will promptly notify American of all changes in said forms. Supervision of all claims under said insurances shall be handled by Old Republic. The liability of American shall follow the liability of Old Republic in accordance with the terms and conditions of said insurances.

ARTICLE V

In the event of the insolvency of Old Republic, the reinsurance under this treaty shall be payable by American on the basis of the claim or claims allowed against the insolvent Old Republic by any court of competent jurisdiction or any justice or judge thereof, or by any receiver or liquidator having authority to determine and allow such claims. It is agreed, however, that the liquidator, receiver or statutory successor of Old Republic will be required to give written notice to American of the pendency of a claim against Old Republic on the policy reinsured within a reasonable time after such claim is filed, and that during the pendency period of such claim, American may investigate such claim and interpose, at its own expense, in the proceeding where such claim is to be adjudicated, any defense or defenses which it may deem available to Old Republic or its liquidator or receiver or statutory successor. The expense thus incurred by American shall be chargeable, subject to

court approval, against Old Republic as part of the expense of liquidation to the extent of a proportionate share of the benefit which may accrue to Old Republic solely as a result of the defense undertaken by American.

ARTICLE VI

In the event of the insolvency, bankruptcy, rehabilitation, receivership or liquidation of American, Old Republic may retain all or any portion of any amount due under this treaty for the purpose of paying any and all losses of policyholders and expenses pertaining thereto which arise or may arise under the insurances reinsured under this treaty. When all losses have been paid, Old Republic shall pay to American the full amount of any balance of the reinsurance premium then remaining.

ARTICLE VII

A. This treaty may, by mutual consent, be altered in any of its terms and conditions by a signed addendum thereto.

B. This treaty may be terminated by either party effective on the last day of any renewal period upon thirty (30) days' written notice to the other party, in which event American, by written notice given to Old Republic at any time prior to the effective date of such termination, may elect to continue this agreement from month to month but only as respects said insurances issued by Old Republic before the effective date of termination; provided that American at its option and upon at least thirty (30) days' written notice may terminate this agreement on the last day of any month as to all such insurances on which American had previously elected to continue on a month-to-month basis. It is understood that any liability of American arising under its reinsurances of said policies under such election is on a month-to-month basis only and is limited solely to such excess amount as shall become payable under Article III of this agreement by American to Old Republic in any month during which American elects that this agreement may continue.

ARTICLE VIII

This treaty may be executed in any number of counterparts and all executed counterparts shall be originals.

IN WITNESS WHEREOF, the parties hereto have caused this instrument to be duly executed and sealed by their respective corporate seals on this ——— day of ———, 1961.

OLD REPUBLIC LIFE INSURANCE COMPANY,
By CHARLES S. WILKES.

Attest:

———— ————, *Secretary.*

AMERICAN UNIVERSAL LIFE INSURANCE COMPANY,

By ———— ————.

Attest:

———— ————, *Secretary.*

AMERICAN UNIVERSAL LIFE INSURANCE COMPANY,
Clayton 5, Mo., April 11, 1961.

Mr. G. W. KRAMER,
Vice President, Old Republic Life Insurance Company,
307 North Michigan Avenue,
Chicago, Illinois.

DEAR BILL: Reference is made to the Disability Reinsurance Treaty executed between our Companies on March 23, 1961, effective January 1, 1961.

This letter is intended as a modification of said Treaty and a clarification of the manner of transmittal of reinsurance premiums.

Sub paragraph A of Article III states ". . . the unearned premium reserves being computed on a monthly pro rata basis." It is my definite understanding that this computation will be made solely on the rule of the sum-of-the-digits (Rule of "78").

The procedure to be followed in making remittances under this Treaty will be as follows:

(1) All computations of the unearned premium on the Rule of 78 will be made by American Universal. This computation will be made as of the close of each calendar quarter

in the form of a summary of machine tabulated run. In addition thereto a detailed tabular run will be furnished your Company by American Universal shortly after December 31st of each year.

(2) It will not be necessary for your Company to make any remittances of the reinsurance premium under this Treaty until it receives a summary of the machine tabular run as of September 30, 1961.

(3) If the net premiums written under this Treaty are less than the unearned premiums under the summary of the machine tabular run then no remittance need be made until your Company receives the summary of the machine tabular run as of December 31, 1961.

(4) If the total of the net A & H premiums written under this Treaty up to and including September 30th are greater than the summary of the machine tabular run as of September 30, 1961 the difference shall be remitted forthwith by your Company to American Universal as the reinsurance premium on said business.

(5) Thereafter we shall arbitrarily consider the written net premiums on disability insurance each month to be the same as the earned premium for that month. Any fluctuations in the unearned premium reserve determined by the summary of the machine tabulated run shall be adjusted either upward or downward in the remittance of the earned reinsurance premium for the following month.

Please return the original to this letter.

Respectfully yours,

AMERICAN UNIVERSAL LIFE INSURANCE COMPANY,

By JOSEPH KUTTEN, *President.*

CHICAGO, ILLINOIS.

This, 20 day of April, 1961.

To: American Universal Life Insurance Company

GENTLEMEN: The contents of this letter are acceptable to our Company.

CHARLES S. WILKES,
Administrative Vice President.

ADDENDUM No. 2 TO REINSURANCE TREATY No. 7

This Addendum attached to and made a part of a Reinsurance Treaty entered into by OLD REPUBLIC LIFE INSURANCE COMPANY, Chicago, Illinois (therein called "Old Republic" and American Universal Life Insurance Co., Clayton, Missouri, (therein called "American Universal") on the 23rd day of March, 1961.

Witnesseth:

It is hereby agreed between the parties hereto that Article V of the said Reinsurance Treaty is deleted and the following substituted therefor:

"ARTICLE V

In the event of the insolvency of Old Republic, the insurances under this treaty shall be payable without diminution because of Old Republic's insolvency by American Universal to Old Republic's liquidator, receiver or statutory successor on the basis of the claim or claims allowed on said insurances against the insolvent Old Republic by any court of competent jurisdiction or any justice or judge thereof, or by any receiver, liquidator or statutory successor having authority to determine and allow such claims. It is agreed, however, that the liquidator, receiver or statutory successor of Old Republic shall have to give written notice to American Universal of the pending of a claim against Old Republic on this treaty within reasonable time after such claim is filed in the insolvency proceeding and that during the pendency of such claim, American Universal may investigate such claim and interpose, at its own expense, in the proceeding where such claim is to be adjudicated any defense or defenses which it may deem available to Old Republic or its liquidator, receiver or statutory successor. The expense thus incurred by American Universal shall be chargeable subject to court approval, aganist Old Republic as a part of the expense of liquidation to the extent of a proportionate share of the benefits which may accrue to Old Republic

solely as a result of the defense undertaken by American Universal."

This Addendum is effective retroactively to the first day of May 1963.

IN WITNESS WHEREOF, the parties have signed this addendum the 7th day of February, 1964.

OLD REPUBLIC LIFE INSURANCE COMPANY,

By CHARLES S. WILKES.

AMERICAN UNIVERSAL LIFE INSURANCE CO.,

By JOSEPH KUTTEN, *Pres.*

EXHIBIT 3

CREDIT LIFE REINSURANCE AGREEMENT

Between

PILOT LIFE INSURANCE COMPANY of Greensboro, North Carolina, herein called "Pilot Life,"

and

AMERICAN UNIVERSAL LIFE INSURANCE COMPANY of Clayton, Missouri, herein called "American Universal."

ARTICLE I

On and after February 1, 1957, Pilot Life agrees to reinsure with American Universal one hundred per cent (100%) of the total of all Credit Life issued by Pilot Life covering the debtors of Aetna Finance Company, its affiliates and subsidiaries, and American Universal agrees to accept such reinsurance automatically.

ARTICLE II

1. The liability of American Universal on all reinsurances shall begin simultaneously with that of Pilot Life and in no event shall the reinsurance of American Universal be in force and binding unless the policy issued by Pilot Life is in force.

2. In all reinsurances the liability of American Universal shall cease when the liability of Pilot Life ceases.

3. If, through inadvertence or oversight, Pilot Life fails to notify American Universal of automatic reinsurance on any risk upon which American Universal should have been bound in accordance with the terms of this agreement, such reinsurance shall nevertheless be held to be in force.

ARTICLE III

1. Reinsurance payments to American Universal shall be made on or before the twenty-fifth day of each calendar month based on premium received by Pilot Life during the preceding calendar month on all policies reinsured by American Universal.

2. The premium for all reinsurance under this agreement shall be ninety-eight per cent (98%) of the adjusted gross premiums for all policies reinsured hereunder. Adjusted gross premium is gross premium paid less any premium refunded for cancellation of insurances.

3. From the reinsurance premium due American Universal shall be deducted and withheld by Pilot Life:

A. the following expenses which are assumed by American Universal;

(1) all premium, occupational and privilege taxes applicable to the insurance,

(2) the cost of policy forms,

(3) any special claim expense incurred by Pilot Life in accordance with Section 3 of Article IV hereof, and

(4) any commissions paid to or retained by agents for writing the insurance; and

B. the total of all claims paid under reinsured policies during the period for which the reinsurance premium is due.

4. If, at the time established for making any premium remittance, the total of the deductions listed in the preceding Section of this Article exceeds ninety-eight per cent (98%) of the adjusted gross premium for the period covered, American Universal shall pay to Pilot Life the amount of such excess upon receipt of a statement of the amount of such excess.

5. American Universal shall maintain reserves on all insurance reinsured under this agreement either on the basis required by the State of Missouri or on the basis required by any other state where such insurance is issued, whichever basis produces the larger reserve.

6. If this agreement is terminated as to new reinsurance, American Universal shall, nevertheless, be liable to Pilot Life for payment of all claims arising out of insurance previously reinsured hereunder and shall pay Pilot Life the amount of any such claims paid by Pilot Life upon receipt of a statement of the amount of any such claims.

ARTICLE IV

1. American Universal shall be liable to Pilot Life for the benefits covered by reinsurance hereunder to the same extent as Pilot Life is liable to the persons insured for such benefits and all reinsurance shall be subject to the terms and conditions of the policy under which Pilot Life is liable.

2. Whenever a claim is made under a policy of Pilot Life reinsured under this agreement, it shall be considered by American Universal to be a claim for the full amount of reinsurance on such policy and American Universal shall abide by the settlement made by Pilot Life and shall pay the full amount of reinsurance.

3. Any suit or claim may be contested or compromised on the part of Pilot Life and in case of reduction of the claim made upon Pilot Life, the claim made upon American Universal shall be reduced accordingly. Any special expense incurred by Pilot Life in defending or investigating any claim shall be borne by American Universal. Compensation of officers and employees of Pilot Life shall not be deemed a claim expense.

4. On or before the twenty-fifth day of each January, Pilot Life shall furnish American Universal a statement showing the amount of insurance in force under this agreement, the amount of the earned premium, the amount of the unearned premium, and the totals of all claims and expenses under policies reinsured hereunder during the preceding calendar year, all as of December thirty-first of the preceding year.

ARTICLE V

1. This agreement shall be unlimited in its duration except that it may be terminated as to new reinsurance at any time upon written notice of either party to the other.

2. This agreement may be altered at any time by mutual consent of the parties, either by addendum or by correspondence signed by responsible officials of the parties, and such addendum or correspondence shall be binding on the parties and be deemed to be an integral part of this agreement.

ARTICLE VI

American Universal shall have the right and opportunity at any reasonable time to inspect all records of Pilot Life relating to reinsurance under this agreement.

ARTICLE VII

1. Any disputes and differences between the two parties to this agreement upon which an amicable understanding cannot be reached are to be decided by arbitration and the arbitrators, who shall regard this agreement from the standpoint of practical business and equity rather than from that of strict law, are empowered to determine as to the interpretation of the treaty obligation.

2. The court of arbitration, which is to be held in the City of Greensboro, North Carolina, shall consist of three arbitrators who must be officers of life insurance companies other than the parties to this agreement. One of the arbitrators is to be appointed by Pilot Life, the second by American Universal and the third is to be selected by these two representatives before the beginning of the arbitration. Should one of the parties decline to appoint an arbitrator or should the two arbitrators fail to agree on a third, the appointment shall be made by the president of the Life Insurers Conference.

3. The arbitrators are not bound by any rules of law. They shall decide by a majority of votes and from their written decision there can be no appeal. The cost of arbitration shall be borne by the losing party unless the arbitrators shall decide otherwise.

ARTICLE VIII

This is an agreement solely between Pilot Life and American Universal. The acceptance of reinsurance hereunder shall not create any right or legal relation whatever between American Universal and any person insured or any beneficiary under any policy of Pilot Life which may be reinsured hereunder.

IN WITNESS WHEREOF, Pilot Life Insurance Company and American Universal Life Insurance Company, have, by their respective officers, executed and delivered this agreement in duplicate, this 2nd day of July, 1957.

PILOT LIFE INSURANCE COMPANY,
By R. J. JONES,
Group Actuary.

Attest:
_____ _____, *Secretary.*

AMERICAN UNIVERSAL LIFE INSURANCE COMPANY,
By JOSEPH KUTTEN,
President.

Attest:
_____ _____, *Secretary.*

[Rider No. 1]

PILOT LIFE INSURANCE COMPANY,
Greensboro, N.C.

Rider to be attached to and made part of Credit Life Reinsurance Agreement issued to AMERICAN UNIVERSAL LIFE INSURANCE COMPANY.

Amendment to be attached to and made a part of Credit Life Reinsurance Agreement between Pilot Life Insurance Company and American Universal Life Insurance Company bearing the effective date of February 1, 1957.

Said Agreement is hereby amended, effective December 1, 1961, by substituting for the words and figures "ninety-eight percent (98%)" where they appear in sections 2 and 4 of Article III of said Agreement the words and figures "ninety eight and three-fourths percent (98¾%)".

This change in reinsurance premium rates shall apply to premiums for the calendar month December 1961 and thereafter.

Any provisions of the Reinsurance Agreement inconsistent with the terms of this Rider are hereby declared void and of no effect.

Nothing contained in this Rider shall be construed to alter or amend any provisions of the Reinsurance Agreement except as specifically provided herein.

JANUARY 17, 1962.

PILOT LIFE INSURANCE COMPANY,
By ———— ————, *Secretary.*
———— ————, *Registar.*

AMERICAN UNIVERSAL LIFE INSURANCE COMPANY,
By JOSEPH KUTTEN.
CASIMER L. MUSULAK, *Witness.*

[Rider No. 2]

PILOT LIFE INSURANCE COMPANY,
Greensboro, N.C.

Rider to be attached to and made part of Credit Life Reinsurance Agreement issued to AMERICAN UNIVERSAL LIFE INSURANCE COMPANY. Effective February 1, 1957.

The above described Reinsurance Agreement is hereby amended, effective September 30, 1963, by adding to Article IV thereof the following section 5:

"5—As of September 30, 1964 and annually thereafter, American Universal may determine experience premium refunds with respect to the insurance under Creditors Group Life Insurance Policies numbers 32,527 and 32,528 issued by Pilot Life to Aetna Finance Company, a Missouri Corporation, and each of its wholly owned Texas subsidiary corporations and reinsured under this Agreement and shall pay such premium refunds to Pilot Life. Upon receipt of such premium refunds, Pilot Life shall immediately pay the entire amount of such refunds to Aetna Finance Company under the premium refund provisions of the said Group Policies.

Such premium refunds shall be determined by subtracting from eighty-five percent (85%) of the cumulative total of the life insurance premiums earned under such Group Policies the cumulative total of all

death claims incurred under such Group Policies and the cumulative total of all premium refunds made under the terms of this provision."

Any provisions of the Reinsurance Agreement inconsistent with the term of this Rider are hereby declared void and of no effect.

Nothing contained herein shall be construed to alter or amend any provisions of the Reinsurance Agreement except as specifically provided herein.

JANUARY 31, 1964.

———— ————, *Registrar.*

Date: Feb. 5, 1964.

PILOT LIFE INSURANCE COMPANY,
By ———— ————, *Secretary.*

AMERICAN UNIVERSAL LIFE INSURANCE COMPANY,
By JOSEPH KUTTEN, *Pres.*

Witness: GERALD M. KANTOR.

EXHIBIT 4

ACCIDENT AND HEALTH REINSURANCE AGREEMENT

Between

PILOT LIFE INSURANCE COMPANY of Greensboro, North Carolina, herein called "Pilot Life,"

and

AMERICAN UNIVERSAL LIFE INSURANCE COMPANY of Clayton, Missouri, herein called "American Universal."

ARTICLE I

On and after July 1, 1957, Pilot Life agrees to reinsure with American Universal one hundred per cent (100%) of the total of all Credit Accident and Health issued by Pilot Life covering the debtors of Aetna Finance Company, its affiliates and subsidiaries, and American Universal agrees to accept such reinsurance automatically.

ARTICLE II

1. The liability of American Universal on all reinsurances shall begin simultaneously with that of Pilot Life and in no event shall the reinsurance of American Universal be in force and binding unless the policy issued by Pilot Life is in force.

2. In all reinsurances the liability of American Universal shall cease when the liability of Pilot Life ceases.

3. If, through inadvertence or oversight, Pilot Life fails to notify American Universal of automatic reinsurance on any risk upon which American Universal should have been bound in accordance with the terms of this agreement, such reinsurance shall nevertheless be held to be in force.

ARTICLE III

1. Reinsurance payments to American Universal shall be made on or before the twenty-fifth of each calendar month, on a monthly term basis, based on all accident and health insurance in force during the previous month on policies reinsured with American Universal.

2. The premium payable in any month shall be ninety-eight per cent (98%) of the earned premiums for the previous month for all accident and health policies reinsured hereunder. Earned premiums for any month on such policies are all premiums written during such month, less returned premiums on such policies during such month, plus the unearned premium reserves on such policies at the beginning of such month, and less the unearned premium reserves on such policies at the end of such month.

3. From the reinsurance premium due American Universal shall be deducted and withheld by Pilot Life:

A. the following expenses which are assumed by American Universal:

(1) all premium, occupational and privilege taxes applicable to the insurance,

(2) the cost of policy forms,

(3) any special claim expense incurred by Pilot Life in accordance with Section 3 of Article IV hereof, and

(4) any commissions paid to or retained by agents for writing the insurance; and

B. the total of all claims paid under reinsured policies during the period for which the reinsurance premium is due.

4. If, at the time establish for making any premium remittance, the total of the deductions listed in the preceding Section of this Article exceeds ninety-eight per cent (98%) of the earned premium for the period covered, American Universal shall pay to Pilot Life the amount of such excess upon receipt of a statement of the amount of such excess.

5. If this agreement is terminated as to new insurance, Pilot Life shall nevertheless be liable to American Universal for payment of monthly reinsurance premiums until all premiums on policies reinsured with American Universal prior to the termination have been earned, and American Universal shall nevertheless be liable to Pilot Life for payment of all claims arising out of policies reinsured with American Universal prior to the termination. After all reinsurance premiums have been paid, American Universal shall pay Pilot Life the amount of any claims on such reinsured policies, which claims were paid by Pilot Life and not deducted from reinsurance premiums, upon receipt of a statement of the amount of any such claims.

ARTICLE IV

1. American Universal shall be liable to Pilot Life for the benefits covered by reinsurance hereunder to the same extent as Pilot Life is liable to the persons insured for such benefits and all reinsurance shall be subject to the terms and conditions of the policy under which Pilot Life is liable.

2. Whenever a claim is made under a policy of Pilot Life reinsured under this agreement, it shall be considered by American Universal to be a claim for the full amount of reinsurance on such policy and American Universal shall abide by the settlement made by Pilot Life and shall pay the full amount of reinsurance.

3. Any suit or claim may be contested or compromised on the part of Pilot Life and in case of reduction of the claim

made upon Pilot Life, the claim made upon American Universal shall be reduced accordingly. Any special expense incurred by Pilot Life in defending or investgating any claim shall be borne by American Universal. Compensation of officers and employees of Pilot Life shall not be deemed a claim expense.

4. On or before the twenty-fifth day of each January, Pilot Life shall furnish American Universal a statement showing the amount of insurance in force under this agreement, the amount of the earned premium, the amount of the unearned premium, and the totals of all claims and expenses under policies reinsured hereunder during the preceding calendar year, all as of December thirty-first of the preceding year.

ARTICLE V

1. This agreement shall be unlimited in its duration except that it may be terminated as to new reinsurance at any time upon written notice of either party to the other.

2. This agreement may be altered at any time by mutual consent of the parties, either by addendum or by correspondence signed by responsible officials of the parties, and such addendum or correspondence shall be binding on the parties and be deemed to be an integral part of this agreement.

ARTICLE VI

American Universal shall have the right and opportunity at any reasonable time to inspect all records of Pilot Life relating to reinsurance under this agreement.

ARTICLE VII

1. Any disputes and differences between the two parties to this agreement upon which an amicable understanding cannot be reached are to be decided by arbitration and the arbitrators, who shall regard this agreement from the standpoint of practical business and equity rather than from that of strict law, are empowered to determine as to the interpretation of the treaty obligation.

2. The court of arbitration, which is to be held in the City of Greensboro, North Carolina, shall consist of three arbitrators who must be officers of life insurance companies other than the parties to this agreement. One of the arbitrators is to be appointed by Pilot Life, the second by American Universal and the third is to be selected by these two representatives before the beginning of the arbitration. Should one of the parties decline to appoint an arbitrator or should the two arbitrators fail to agree on a third, the appointment shall be made by the president of the Life Insurers Conference.

3. The arbitrators are not bound by any rules of law. They shall decide by a majority of votes and from their written decision there can be no appeal. The cost of arbitration shall be borne by the losing party unless the arbitrators shall decide otherwise.

ARTICLE VIII

This is an agreement solely between Pilot Life and American Universal. The acceptance of reinsurance hereunder shall not create any right or legal relation whatever between American Universal and any person insured or any beneficiary under any policy of Pilot Life which may be reinsured hereunder.

IN WITNESS WHEREOF, Pilot Life Insurance Company and American Universal Life Insurance Company, have, by their respective officers, executed and delivered this agreement in duplicate, this 2nd day of July, 1957.

PILOT LIFE INSURANCE COMPANY,
By R. J. JONES, *Group Actuary*

Attest:

———— ————, *Secretary.*

AMERICAN UNIVERSAL LIFE INSURANCE COMPANY,

By
JOSEPH KUTTEN, *President.*

Attest:

M. BROWN.

[Rider No. 1]

PILOT LIFE INSURANCE COMPANY,
Greensboro, N.C.

Rider to be attached to and made a part of Accident and Health Reinsurance Agreement issued to AMERICAN UNIVERSAL LIFE INSURANCE COMPANY.

Amendment to be attached to and made a part of Accident And Health Reinsurance Agreement between Pilot Life Insurance Company and American Universal Life Insurance Company bearing the effective date of July 1, 1957.

Said Agreement is hereby amended, effective December 1, 1961, by substituting for the words and figures "ninety-eight percent (98%)" where they appear in sections 2 and 4 of Article III of said Agreement the words and figures "ninety eight and three-fourths percent (98¾%)".

This change in reinsurance premium rates shall apply to premiums for the calendar month December 1961 and thereafter.

Any provisions of the Reinsurance Agreement inconsistent with the terms of this Rider are hereby declared void and of no effect.

Nothing contained in this Rider shall be construed to alter or amend any provisions of the Reinsurance Agreement except as specifically provided herein.

JANUARY 17, 1962.

PILOT LIFE INSURANCE COMPANY,
By ———— ————, *Secretary.*

———— ————, *Registrar.*

AMERICAN UNIVERAL LIFE INSURANCE COMPANY,
By JOSEPH KUTTEN.

CASIMER L. MUSULAK, *Witness.*

[Rider No. 2]

PILOT LIFE INSURANCE COMPANY,
Greensboro, N.C.

Rider to be attached to and made a part of Credit Accident and Health Reinsurance Agreement—Effective July 1, 1957 issued to AMERICAN UNIVERAL LIFE INSURANCE COMPANY.

The above described Reinsurance Agreement is hereby amended, effective September 30, 1963, by adding to Article IV thereof the following section 5:

"5—As of September 30, 1964 and annually thereafter, American Universal may determine experience premium refunds with respect to the insurance under Creditors Group Accident and Health Insurance Policy number 32,528 issued by Pilot Life to Aetna Finance Company, a Missouri Corporation, and each of its wholly owned Texas subsidiary corporations and reinsured under this Agreement and shall pay such premium refunds to Pilot Life. Upon receipt of such premium refunds, Pilot Life shall immediately pay the entire amount of such refunds to Aetna Finance Company under the premium refund provisions of the said Group Policy.

Such premium refunds shall be determined by subtracting from eighty-five percent (85%) of the cumulative total of the accident and health insurance premiums earned under such Group Policy the cumulative total of all accident and health claims incurred under such Group Policy and the cumulative total of all premium refunds made under the terms of this provision."

Any provisions of the Reinsurance Agreement inconsistent with the terms of this Rider are hereby declared void and of no effect.

Nothing contained herein shall be construed to alter or amend any provisions of the Reinsurance Agreement except as specifically provided herein.

JANUARY 31, 1964.

PILOT LIFE INSURANCE COMPANY,
By ———— ————, *Secretary.*

———— ————, *Registrar.*

Date: Feb. 5, 1964.

AMERICAN UNIVERAL LIFE INSURANCE COMPANY,
By JOSEPH KUTTEN, Pres.

Witness: GERALD M. KANTOR.

EXHIBIT 5

Credit Life Reinsurance Agreement

Between

National Fidelity Life Insurance Company of Kansas City, Missouri, herein called "National Fidelity,"

and

American Universal Life Insurance Company of Clayton, Missouri, herein called "American Universal."

ARTICLE I

On and after February 1, 1957, National Fidelity agrees to reinsure with American Universal one hundred per cent (100%) of the total of all Credit Life issued by National Fidelity covering the debtors of Aetna Finance Company, its affiliates and subsidiaries, and American Universal agrees to accept such reinsurance automatically.

ARTICLE II

1. The liability of American Universal on all reinsurances shall begin simultaneously with that of National Fidelity and in no event shall the reinsurance of American Universal be in force and binding unless the policy issued by National Fidelity is in force.

2. In all reinsurances the liability of American Universal shall cease when the liability of National Fidelity ceases.

3. If, through inadvertence or oversight, National Fidelity fails to notify American Universal of automatic reinsurance on any risk upon which American Universal should have been bound in accordance with the terms of this agreement, such reinsurance shall nevertheless be held to be in force.

ARTICLE III

1. Reinsurance payments to American Universal shall be made on or before the twenty-fifth day of each calendar month based on premium received by National Fidelity during the preceding calendar month on all policies reinsured by American Universal.

2. The premium for all reinsurance under this agreement shall be ninety-eight per cent (98%) of the adjusted gross premiums for all policies reinsured hereunder. Adjusted gross premium is gross premium paid less any premium refunded for cancellation of insurance.

3. From the reinsurance premium due American Universal shall be deducted and withheld by National Fidelity:

A. the following expenses which are assumed by American Universal;

(1) all premium, occupational and privilege taxes applicable to the insurance,

(2) the cost of policy forms,

(3) any special claim expense incurred by National Fidelity in accordance with Section 3 of Article IV hereof, and

(4) any commissions paid to or retained by agents for writing the insurance; and

B. the total of all claims paid under reinsured policies during the period for which the reinsurance premium is due.

4. If, at the time established for making any premium remittance, the total of the deductions listed in the preceding Section of this Article exceeds ninety-eight per cent (98%) of the adjusted gross premium for the period covered, American Universal shall pay to National Fidelity the amount of such excess upon receipt of a statement of the amount of such excess.

5. American Universal shall maintain reserves on all insurance reinsured under this agreement either on the basis required by the state of Missouri or on the basis required by any other state where such insurance is issued, whichever basis produces the larger reserve.

6. If this agreement is terminated as to new reinsurance, American Universal shall, nevertheless, be liable to National Fidelity for payment of all claims arising out of insurance previously reinsured hereunder and shall pay National Fidelity the amount of any such claims paid by National Fidelity upon receipt of a statement of the amount of any such claims.

ARTICLE IV

1. American Universal shall be liable to National Fidelity for the benefits covered by reinsurance hereunder to the same extent as National Fidelity is liable to the persons insured for such benefits and all reinsurance shall be subject to the terms and conditions of the policy under which National Fidelity is liable.

2. Whenever a claim is made under a policy of National Fidelity reinsured under this agreement, it shall be considered by American Universal to be a claim for the full amount of reinsurance on such policy and American Universal shall abide by the settlement made by National Fidelity and shall pay the full amount of reinsurance.

3. Any suit or claim may be contested or compromised on the part of National Fidelity and in case of reduction of the claim made upon National Fidelity, the claim made upon American Universal shall be reduced accordingly. Any special expense incurred by National Fidelity in defending or investigating any claim shall be borne by American Universal. Compensation of officers and employees of National Fidelity shall not be deemed a claim expense.

4. On or before the twenty-fifth day of each January, National Fidelity shall furnish American Universal a statement showing the amount of insurance in force under this agreement, the amount of the earned premium, the amount of the unearned premium, and the totals of all claims and expenses under policies reinsured hereunder during the preceding calendar year, all as of December thirty-first of the preceding year.

ARTICLE V

1. This agreement shall be unlimited in its duration except that it may be terminated as to new reinsurance at any time upon written notice of either party to the other.

2. This agreement may be altered at any time by mutual consent of the parties, either by addendum or by correspondence signed by responsible officials of the parties, and such addendum or correspondence shall be binding on the parties and be deemed to be an integral part of this agreement.

ARTICLE VI

American Universal shall have the right and opportunity at any reasonable time to inspect all records of National Fidelity relating to reinsurance under this agreement.

ARTICLE VII

1. Any disputes and differences between the two parties to this agreement upon which an amicable understanding cannot be reached are to be decided by arbitration and the arbitrators, who shall regard this agreement from the standpoint of practical business and equity rather than from that of strict law, are empowered to determine as to the interpretation of the treaty obligation.

2. The court of arbitration, which is to be held in the City of Greensboro, North Carolina, shall consist of three arbitrators who must be officers of life insurance companies other than the parties to this agreement. One of the arbitrators is to be appointed by National Fidelity, the second by American Universal and the third is to be selected by these two representatives before the beginning of the arbitration. Should one of the parties decline to appoint an arbitrator or should the two arbitrators fail to agree on a third, the appointment shall be made by the president of the Life Insurers Conference.

3. The arbitrators are not bound by any rules of law. They shall decide by a majority of votes and from their written decision there can be no appeal. The cost of arbitration shall be borne by the losing party unless the arbitrators shall decide otherwise.

ARTICLE VIII

This is an agreement solely between National Fidelity and American Universal. The acceptance of reinsurance hereunder shall not create any right or legal relation whatever between American Universal and any person insured or any beneficiary under any policy of National Fidelity which may be reinsured hereunder.

IN WITNESS WHEREOF, National Fidelity Life Insurance Company and American Universal Life Insurance

Company, have, by their respective officers, executed and delivered this agreement in duplicate, this 2nd day of July, 1957.

NATIONAL FIDELITY LIFE INSURANCE COMPANY,
By ———— ————, *President.*

Attest:

———— ————, *Secretary.*

AMERICAN UNIVERSAL LIFE INSURANCE COMPANY,
JOSEPH KUTTEN, *President.*

Attest:

By ———— ————, *Secretary.*

NATIONAL FIDELITY LIFE INSURANCE COMPANY,
Kansas City, Missouri.

RIDER

Rider to be attached to and made a part of Credit Life Reinsurance Agreement issued to AMERICAN UNIVERSAL LIFE INSURANCE COMPANY.

Amendment to be attached to and made a part of Credit Life Reinsurance Agreement between National Fidelity Life Insurance Company and American Universal Life Insurance Company bearing the effective date of February 1, 1957.

Said Agreement is hereby amended, effective December 1, 1961, by substituting for the words and figures "ninety-eight percent (98%)" where they appear in Sections 2 and 4 of Article III of said Agreement the words and figures "ninety-eight and three-fourths percent (98¾%)".

This change in reinsurance premium rates shall apply to premiums for the calendar month December 1961 and thereafter.

Any provisions of the Reinsurance Agreement inconsistent with the terms of this Rider are hereby declared void and of no effect.

Nothing contained in this Rider shall be construed to alter or amend any provisions of the Reinsurance Agreement except as specifically provided herein.

FEBRUARY 7, 1962.

NATIONAL FIDELITY LIFE INSURANCE COMPANY,

By _____ _____,

Executive Vice President.

RICHARD M. SMITH,

Assistant Secretary.

AMERICAN UNIVERSAL LIFE INSURANCE COMPANY,

By JOSEPH KUTTEN.

_____ _____,

Witness.

EXHIBIT 6

ACCIDENT AND HEALTH REINSURANCE AGREEMENT

Between

NATIONAL FIDELITY LIFE INSURANCE COMPANY of Kansas City, Missouri, herein called "National Fidelity"

and

AMERICAN UNIVERSAL LIFE INSURANCE COMPANY of Clayton, Missouri, herein called "American Universal."

ARTICLE I

On and after July 1, 1957, National Fidelity agrees to reinsure with American Universal one hundred percent (100%) of the total of all Credit Accident and Health issued by National Fidelity covering the debtors of Aetna Finance Company, its affiliates and subsidiaries, and American Universal agrees to accept such reinsurance automatically.

ARTICLE II

1. The liability of American Universal on all reinsurances shall begin simultaneously with that of National Fidelity and in no event shall the reinsurance of American Universal be in force and binding unless the policy issued by National Fidelity is in force.

2. In all reinsurances the liability of American Universal shall cease when the liability of National Fidelity ceases.

3. If, through inadvertence or oversight, National Fidelity fails to notify American Universal of automatic reinsurance on any risk upon which American Universal should have been bound in accordance with the terms of this agreement, such reinsurance shall nevertheless be held to be in force.

ARTICLE III

1. Reinsurance payments to American Universal shall be made on or before the twenty-fifth of each calendar month, on a monthly term basis, based on all accident and health insurance in force during the previous month on policies reinsured with American Universal.

2. The premium payable in any month shall be ninety-eight per cent (98%) of the earned premiums for the previous month for all accident and health policies reinsured hereunder. Earned premiums for any month on such policies are all premiums written during such month, less returned premiums on such policies during such month, plus the unearned premium reserves on such policies at the beginning of such month, and less the unearned premium reserves on such policies at the end of such month.

3. From the reinsurance premium due American Universal shall be deducted and withheld by National Fidelity:

A. the following expenses which are assumed by American Universal:

(1) all premium, occupational and privilege taxes applicable to the insurance,

(2) the cost of policy forms,

(3) any special claim expense incurred by National Fidelity in accordance with Section 3 of Article IV hereof, and

(4) any commissions paid to or retained by agents for writing the insurance; and

B. the total of all claims paid under reinsured policies during the period for which the reinsurance premium is due.

4. If, at the time established for making any premium remittance, the total of the deductions listed in the preceding Section of this Article exceeds ninety-eight per cent (98%) of the earned premium for the period covered, American Universal shall pay to National Fidelity the amount of such excess upon receipt of a statement of the amount of such excess.

5. If this agreement is terminated as to new insurance, National Fidelity shall nevertheless be liable to American Universal for payment of monthly reinsurance premiums until all premiums on policies reinsured with American Universal prior to the termination have been earned, and American Universal shall nevertheless be liable to National Fidelity for payment of all claims arising out of policies reinsured with American Universal prior to the termination. After all reinsurance premiums have been paid, American Universal shall pay National Fidelity the amount of any claims on such reinsured policies, which claims were paid by National Fidelity and not deducted from reinsurance premiums, upon receipt of a statement of the amount of any such claims.

ARTICLE IV

1. American Universal shall be liable to National Fidelity for the benefits covered by reinsurance hereunder to the same extent as National Fidelity is liable to the persons insured for such benefits and all reinsurance shall be subject to the terms and conditions of the policy under which National Fidelity is liable.

2. Whenever a claim is made under a policy of National Fidelity reinsured under this agreement, it shall be considered by American Universal to be a claim for the full amount of reinsurance on such policy and American Universal shall abide by the settlement made by National Fidelity and shall pay the full amount of reinsurance.

3. Any suit or claim may be contested or compromised on the part of National Fidelity and in case of reduction of the claim made upon National Fidelity, the claim made upon American Universal shall be reduced accordingly. Any special expense incurred by National Fidelity in defending or investigating any claim shall be borne by American Uni-

versal. Compensation of officers and employees of National Fidelity shall not be deemed a claim expense.

4. On or before the twenty-fifth day of each January, National Fidelity shall furnish American Universal a statement showing the amount of insurance in force under this agreement, the amount of the earned premium, the amount of the unearned premium, and the totals of all claims and expenses under policies reinsured hereunder during the preceding calendar year, all as of December thirty-first of the preceding year.

ARTICLE V

1. This agreement shall be unlimited in its duration except that it may be terminated as to new reinsurance at any time upon written notice of either party to the other.

2. This agreement may be altered at any time by mutal consent of the parties, either by addendum or by correspondence signed by responsible officials of the parties, and such addendum or correspondence shall be binding on the parties and to be deemed to be an integral part of this agreement.

ARTICLE VI

American Universal shall have the right and opportunity at any reasonable time to inspect all records of National Fidelity relating to reinsurance under this agreement.

ARTICLE VII

1. Any disputes and differences between the two parties to this agreement upon which an amicable understanding cannot be reached are to be decided by arbitration and the arbitraters, who shall regard this agreement from the standpoint of practical business and equity rather than from that of strict law, are empowered to determine as to the interpretation of the treaty obligation.

2. The court of arbitration, which is to be held in the City of Greensboro, North Carolina, shall consist of three arbitrators who must be officers of life insurance companies other than the parties to this agreement. One of the arbitrators is to be appointed by National Fidelity, the second by American Universal and the third is to be selected by these

BEST COPY AVAILABLE

two representatives before the beginning of the arbitration. Should one of the parties decline to appoint an arbitrator or should the two arbitrators fail to agree on a third, the appointment shall be made by the president of the Life Insurers Conference.

3. The arbitrators are not bound by any rules of law. They shall decide by a majority of votes and from their written decision there can be no appeal. The cost of arbitration shall be borne by the losing party unless the arbitrators shall decide otherwise.

ARTICLE VIII

This is an agreement solely between National Fidelity and American Universal. The acceptance of reinsurance hereunder shall not create any right or legal relation whatever between American Universal and any person insured or any beneficiary under any policy of National Fidelity which may be reinsured hereunder.

IN WITNESS WHEREOF, National Fidelity Life Insurance Company and American Universal Life Insurance Company, have, by their respective officers, executed and delivered this agreement in duplicate, this 2nd day of July, 1957.

NATIONAL FIDELITY LIFE INSURANCE COMPANY,

By _____ _____ *Vice President.*

Attest:

_____ _____, *Secretary.*

AMERICAN UNIVERSAL LIFE INSURANCE COMPANY,

By JOSEPH KUTTEN, *President.*

Attest:

_____ _____.

NATIONAL FIDELITY LIFE INSURANCE COMPANY,
Kansas City, Missouri.

RIDER

Rider to be attached to and made a part of Accident and Health Reinsurance issued to AMERICAN UNIVERSAL LIFE INSURANCE COMPANY.

Amendment to be attached to and made a part of Accident and Health Reinsurance Agreement between National Fidelity Life Insurance Company and American Universal Life Insurance Company bearing the effective date of July 1, 1957.

Said Agreement is hereby amended, effective December 1, 1961, by substituting for the words and figures "ninety-eight percent (98%)" where they appear in Sections 2 and 4 of Article III of said Agreement the words and figures "ninety-eight and three-fourths percent (98¾%)".

This change in reinsurance premium rates shall apply to premiums for the calendar month December 1961 and thereafter.

Any provisions of the Reinsurance Agreement inconsistent with the terms of this Rider are hereby declared void and of no effect.

Nothing contained in this Rider shall be construed to alter or amend any provisions of the Reinsurance Agreement except as specifically provided herein.

FEBRUARY 7, 1962.

NATIONAL FIDELITY LIFE INSURANCE COMPANY,

By ———— ————,

Executive Vice President.

RICHARD MACSMITH,

Assistant Secretary.

AMERICAN UNIVERSAL LIFE INSURANCE COMPANY,

By JOSEPH KUTTEN.

HELEN L. ————, *Witness.*

EXHIBIT 24

DIVISION OF INSURANCE

DEPARTMENT OF BUSINESS AND ADMINISTRATION

CERTIFIED COPY

I, ROBERT D. SCHARZ, Superintendent of the Division of Insurance Department of Business and Administration of the State of Missouri, do hereby certify that the annexed pages are a true and correct copy of the original

Report of Examination of the

AMERICAN UNIVERSAL LIFE INSURANCE COMPANY
(Now known as ITT HAMILTON LIFE INSURANCE COMPANY)

as of December 31, 1964.

which said original is now on file in this Division.

IN TESTIMONY WHEREOF, I have hereunto set my hand and caused to be hereto affixed the seal of said Division, at my office in the City of Jefferson, this 10th day of March 19 62

ROBERT D. SCHARZ
SUPERINTENDENT

By
DEPUTY SUPERINTENDENT

By Charles Salmon

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CLAYTON, MISSOURI,
October 8, 1965.

Hon. ROBERT D. SCHARZ,
Superintendent of Insurance, Division of Insurance,
Jefferson City, Missouri.

SIR: In accordance with your certificate of authority, an examination has been made of the records, affairs and financial condition of the AMERICAN UNIVERSAL LIFE INSURANCE COMPANY at its home office and principal place of business located at 111 South Meramec, Clayton, Missouri. This examination began on August 30, 1965, and was concluded on October 8, 1965. The following report of such examination is herewith respectfully submitted.

SCOPE OF EXAMINATION

The American Universal Life Insurance Company, hereinafter referred to as such or as the "Company," was last examined by representatives of your Division as of September 30, 1961. This examination covers the period from that date through December 31, 1964.

The examination included a checking of trial balances into the office copies of the Company's annual reports for the years under review; a testing of income and disbursements to general ledger postings; the verification and evaluation of assets; the establishment of liabilities; and a general review of other records and procedures considered necessary to the examination.

The various balance sheet items are commented on under their respective captions in subsequent sections of this report.

HISTORY

The Company was incorporated on August 8, 1955, as a stipulated premium company for the purpose of writing life and accident and health insurance. The Company commenced business on September 22, 1955.

The initial capitalization of the Company was $50,000.00 consisting of one hundred (100) shares with a par value of $250.00 each and a paid in surplus of $25,000.00. On September 6, 1957, the Articles of Incorporation were amended to increase the capital stock to $100,000.00 consisting of

100,000 shares with a par value of $1.00 each. The increase was accomplished through the declaration of a three hundred (300%) per cent stock dividend. For each share of $250.00 par value stock, the holder was issued 1,000 shares with a par value of $1.00 per share. On September 7, 1965, the capital stock was increased to $1,000,000.00 consisting of 1,000,000 shares with a par value of $1.00 per share and paid for by transfer from surplus. The Company is currently licensed to do the business of life and accident and sickness insurance in accordance with the revised statutes of 1959, and amendments thereto.

MANAGEMENT AND CONTROL

The Company operates on a strictly proprietary plan through a board of directors comprised of nine (9) members elected annually by the stockholders. The board of directors as of December 31, 1964, was comprised of the following members duly elected by the stockholders in accordance with the applicable provisions of the by-laws:

Joseph Kutten
Gerald M. Kantor
David R. Corwin
Edward P. Kessler
Richard L. Yalem
Palmer Shepard
Marcus Brown
Ben Weinbach
Jack Sofian

The duly elected officers of the Company as of December 31, 1964, consisted of the following:

Name/Office

Joseph Kutten, President
Jack Sofian, Vice-President
Gerald M. Kantor, Secretary and Registrar
M. Lerner, Assistant Secretary
Casimir L. Musielak, Treasurer

The ITT Aetna Finance Company owns one hundred (100%) per cent of the Company's outstanding capital stock, and is a subsidiary of the International Telephone and Telegraph Corporation.

CORPORATE RECORDS

The minutes of the meetings of the shareholders and the board of directors for the period under review were in proper order and form. There were four meetings of the board of directors for the period covered by this examination, and perfect attendance was indicated.

There were no changes in the Articles of Incorporation nor the by-laws for the period covered.

FIDELITY BONDS AND OTHER INSURANCE

The Company is protected against fraudulence and/or dishonesty through a blanket fidelity bond covering the International Telephone and Telegraph Corporation and all its subsidiary corporations with the bond being issued by the Aetna Casualty and Security Company, Hartford, Connecticut.

TERRITORY AND PLAN OF OPERATION

As of the examination date, the Company was licensed in Missouri only to do the business of life and accident and sickness insurance. Income is derived principally from credit life insurance and credit accident and health insurance on the debtors of the ITT Aetna Finance Company and from group life and group accident and health insurance on employees of the International Telephone and Telegraph Corporation. All business is obtained entirely through reinsurance facilities.

REINSURANCE

The Company assumes its business through reinsurance agreements with the following companies and the agreements are commented on in the sequence as shown below:

American Bankers Life Assurance Company of Florida, Miami, Florida

Equitable Life Assurance Society of the United States, New York, New York

Insurance City Life Company, Hartford, Connecticut

National Fidelity Life Insurance Company, Kansas City, Missouri

Old Republic Life Insurance Company, Chicago, Illinois, Pilot Life Insurance Company, Greensboro, North Carolina

Under the terms of the reinsurance agreement with the American Bankers Life Assurance Company of Florida the Company assumes a percentage of the liability under certain certificates of life insurance on the lives of Aetna Finance debtors in Nevada. The Company receives monthly a reinsurance premium based on a percentage of all premiums received less premiums returned on certificates surrendered for cancellation with a percentage of incurred losses also being deducted. In the event that the deductions for the return premiums and the losses paid exceed the reinsurance premium payable, the excess is to be paid by the Company to the American Bankers.

The reinsurance agreement with the Equitable Life Assurance Society of the United States pertains to group policies issued by Equitable to the International Telephone and Telegraph Corporation of which policies the Company reinsures a certain portion of the liability falling thereunder. The agreement with Equitable provides that as soon as practicable after the end of each policy year a schedule is to be submitted to the Company by Equitable reflecting the net balance due either the Company or Equitable. Under the terms of the agreement the schedule is to show as a credit to the Company:

1. Preimums computed at a percentage of all insurance under certain group policies at the reinsurance rate.

The debits to the Company under this agreement with Equitable are to be as follows:

2. A percentage of the charge for claims.

3. A percentage of the normal retention charges under the policies as determined by Equitable's dividend formula.

4. A percentage of the normal charges under the policies as computed by Equitable's dividend formula for recovery of prior years' experience deficit.

5. A percentage of the risk charge under the policies as determined by Equitable's dividend formula.

6. The algebraic sum of "a"+"b"−"c"−"d"

with

(a.) being a percentage of (1) above

(b.) being a percentage of the dividend, if any, payable

under the policies as determined by Equitable's dividend formula.

(c.) being a percentage of the excess, if any, over premiums of all charges.

(d.) being equal to the accumulated experience loss adjustment of the prior year's net balance calculation.

7. An accumulated experience loss adjustment equal to the amount, if any, by which item (6) produces a figure less than zero.

Under the terms of the agreement with Equitable, the Company assumes no liability for individual policies issued by Equitable to a previous employee.

A summary of the annual settlement for the policy year from August 1, 1963, to August 1, 1964, by Equitable as submitted in December of 1964 is shown below by the reinsurance schedule items commented on above:

Reinsurance Schedule Items:	*Amounts*
(1) Reinsurance premiums	$2,448,621.50
(2) The percentage of the charge for claims	−1,760,249.62
(3) The percentage of the normal retention charges under policies as determined by Equitable's dividend formula	−99,734.07
(4) Recovery of prior years experience deficit	−28,436.25
(5) Risk charge	−18,056.21
(6a) A percentage of (1) above	−612,155.37
(6b) A percentage of the dividends payable	0
(6c) A percentage of the excess, if any, over premiums of all charges	70,960.37
(7) Accumulated experience loss adjustment	0
Cash amount paid to Company	950.35

The Company's account distribution based on the annual settlement from Equitable as summarized above is detailed as follows:

Group life premiums ITT employees:	
Life	$1,119,896.76
AD and D	65,063.40
	$1,184,960.16
Group A and H premiums ITT employees:	
Weekly indemnity	$18,252.98
Health	1,245,408.36
	$1,263,661.34

Group life claims ITT employees:	
Life	$619,180.12
AD and D	43,050.75
	$662,230.87
Group A and H claims ITT employees:	
Weekly indemnity	$15,887.25
Health	1,082,131.50
	$1,098,018.75
Dividends to life policyholders:	
Life	$467,815.55
AD and D	14,826.96
	$482,642.51
Dividends to A and H policyholders:	
Weekly indemnity	$1,718.24
Health	127,794.62
	$129,512.86
Group services and administration fees, life:	
Life	$32,356.16
AD and D	7,125.14
	$39,481.30
Group services and administration fees, A and H:	
Weekly indemnity	$642.42
Health	35,142.44
	$35,784.86
Cash to Company	$950.85

The Insurance City Life Company cedes to the Company 100% of all the credit life and credit accident and health insurance on business written, covering the debtors of the Aetna Finance Company in Rhode Island. The reinsurance payments are to be made monthly. The reinsurance premium is to be a percentage of the gross premiums paid less any premiums refunded for cancellation with an additional deduction being made for losses sustained. If the losses exceed the reinsurance premiums, the Company is to pay such excess to the Insurance City Life.

The National Fidelity Life Insurance Company cedes to the Company 100% of all credit life and credit accident and health insurance written covering debtors of the Aetna Finance Company, its affiliates and subsidiaries. Reinsurance payments are to be made to the Company monthly. The amount payable is to be a percentage of the earned premiums for accident and health and premiums written for life for the previous month less premium taxes, cost of policy forms, special claim expenses, agents' commissions, and claims paid. If the deductions exceed this percentage of the earned premiums then the Company is obligated to pay National Fidelity the amount of such excess.

The Company reinsures all the life insurance written by the Old Republic Life Insurance Company insuring the lives of certain debtors of the Aetna Finance Company and its subsidiaries. Under this reinsurance contract with Old Republic, the reinsurance premium is to be a percentage of the gross premiums less returns on account of cancellations. Old Republic is to pay all agents' and brokers' commissions and taxes imposed by the states. Old Republic is entitled to set off losses incurred against the reinsurance premuim due the Company. If the incurred losses exceed the reinsurance premium, the Company must pay Old Republic the amount of the resulting excess. The Company also has a reinsurance contract with Old Republic whereby the Company reinsures all disability written in combination with life insurance and all accident and health insurances providing coverage for certain debtors of the Aetna Finance Company and its subsidiaries. The reinsurance premium is to be based on a percentage of the monthly earned premiums, with Old Republic being entitled to set off losses incurred against the reinsurance premium due the Company.

The Company is the "assuming company" in several agreements with the Pilot Life Insurance Company. One agreement states that the Company assumes all insurance under a group policy issued by Pilot to the Aetna Finance Company with the exceptions of accidental death and dismemberment insurance and that part of the group life insurance on any employee exceeding $12,000.00. The reinsurance premium shall be computed on the basis of a percentage of the premium for the group policy. Pilot shall

deduct from the reinsurance premium due all special claim expense and excess morbidity charges of $65.00 for each $1,000.00 converted to individual policies and the total of all claims paid for the applicable month. If the total of the deductions exceeds the reinsurance premium otherwise due the Company, the Company must pay Pilot for the excess immediately upon the receipt of the statement.

The Company also has agreements with Pilot pertaining to credit life and credit accident and health insurance covering certain debtors of the Aetna Finance Company. The reinsurance premium payable is based on a percentage of the earned premiums for accident and health and premiums written for life for the applicable month. Pilot shall deduct from the reinsurance premium due the premium taxes, cost of policy forms, special claim expense, commissions for writing the insurance, and the total of all claims paid. Experience premium refunds may be determined by the Company for certain creditors' group policies issued by Pilot to Aetna Finance Company and each of its wholly owned Texas subsidiaries. Such refunds are to ge paid by the Company to Pilot and Pilot is to pay the entire amount to the Aetna Finance Company. The premium refunds are to be determined by taking a percentage of the cumulative total of the premiums earned less the cumulative total of all death claims incurred. The experience premium refund is to be determined annually.

In addition the Company has another reinsurance contract with Pilot whereby the Company reinsures 100% of the credit life and credit accident and health insurance written by Pilot in connection with loans made under the provisions of the North Carolina Consumer Finance Act to borrowers from the Aetna Finance Company and its affiliates. Under the terms of this agreement the reinsurance premium due the Company shall be based on a percentage of the premiums charged less any premiums refunded for cancellations. Agents commissions are deducted from the reinsurance premiums. Also under the terms of this reinsurance contract Pilot must establish a reserve equal to a percentage of the cumulative total of adjusted gross premiums. If claims and special claim expense exceed this reserve, the Company is to pay to Pilot the excess thus produced.

STATUTORY DEPOSIT

The Company had on deposit with your Division as of December 31, 1964, United States Treasury bonds with an aggregate par value of $606,000.00. The bonds were verified by a certified listing from your Division. On September 7, 1965, this deposit was increased to $2,406,000.00, par value, in United States Treasury bonds.

DIVISIONS

Stockholders

No dividends were declared or paid to stockholders for the period under review.

Policyholders

The company beginning August 1, 1963, assumed a portion of the group business written by the Equitable Life Assurance Society of the United States covering employees of the International Telephone and Telegraph Corporation. Settlement under the contract pertaining to this segment of business is made annually in December for the policy year which runs from August to August. The statement furnished by Equitable to the Company reflected as dividends paid to policyholders the following described amounts:

Life policyholders	$482,642.51
Accident and health policyholders	129,512.86
Total	$612,155.37

GROWTH OF COMPANY

The growth of the Company during the past four years is shown in the following table setting forth insurance in force, admitted assets, capital, and surplus. The figures for 1964 were taken from the financial statement presented subsequently herein, and the figures for 1961, 1962, and 1963 were taken from the respective annual statements.

Year	Insurance in force	Admitted Assets	Capital	Surplus
1961	$53,887,356	$1,776,700	$100,000	$935,590
1962	72,021,493	3,551,944	100,000	2,123,198
1963	88,300,524	4,682,437	100,000	3,073,911
1964	221,383,507	6,590,291	100,000	4,205,352

CONFLICT OF INTEREST

Members of the board of directors and officers annually sign a statement addressed to the board of directors which reads as follows:

I, the undersigned, hereby affirm that I have no material interest or affiliation which is in conflict with my official duties or is likely to conflict with such duties. If there is any such possible conflicting interest or interests this interest or interests are listed below.

ACCOUNT AND RECORDS

The Company manually maintains a general ledger, a disbursements journal, a cash receipts journal, and a general journal. The subsidiary ledger for investments consists of card files with all necessary items pertaining to the investment being entered and maintained on an individual record for each investment. Cash trial balances for the years under review were furnished by the Company, were checked into the general ledger, and were compared and reconciled to the annual statements. Various accruals of reinsurance premiums receivable, claims, and reserves are posted to the general ledger accounts.

An electronic data processing unit aids in the computations of reserves. A seriatim listing of reserves was supplied the Company by the data processing equipment as of December 31, 1964.

FINANCIAL STATEMENT

The following financial statement, with supporting schedules and exhibits, presents the financial condition of the Company as of December 31, 1964, as determined by this examination:

ASSETS

Bonds	$4,687,581.71
Stocks	130,000.00
Cash and Bank Deposits	362,097.90
Reinsurance premiums receivable	1,371,011.50
Interest due and accrued	39,500.67
Total Assets	$6,590,290.78

LIABILITIES, SURPLUS AND OTHER FUNDS

Aggregate reserve for life policies	$806,698.00
Aggregate reserve for accident and health policies	59,673.48
Policy and contract claims:	
Life	300,309.20
Accident and Health	602,293.65
Policyholders dividends payable in following year: Not yet apportioned	263,700.00
Commissions to agents due or accrued: Life $57,643.37: A&H $66,201.83	123,845.20
General expenses due or accrued	68,721.95
Taxes, license and fees due or accrued "excl. Federal Income Taxes"	5,096.84
Federal Income Taxes due or accrued	21,787.70
Mandatory securities valuation reserve	32,813.06
Total Liabilities	$2,284,939.08
Capital paid-up	$100,000.00
Unassigned surplus	4,205,351.70
Total capital and surplus	4,305,351.70
Total liabilities, capital and surplus	$6,590,290.78

Summary of Operations

Premiums and annuity considerations:	
Life	$3,333,346.39
Accident and Health	3,514,640.59
Net investment income	139,370.52
Total	$6,987,357.50
Deduct:	
Death benefits	$1,365,626.63
Group conversions	1,495.00
Benefits under accident and health policies	2,101,488.52
Increase in reserve for policies and contracts with life contingencies	73,319.00
Increase in aggregate reserve for accident and health policies	20,333.80
Subtotal	$3,562,262.95
Commissions on premiums	786,750.91
General insurance expenses	223,906.84
Insurance taxes, licenses and fees "excl. Fed. Inc. Tax"	13,223.71
Total	$4,586,144.41
Net gain from operations before div. to policyholders and Fed. Inc. Tax	$2,401,213.09

Div. to life policyholders	$721,942.51
Div. on accident and health policies	153,912.86
Total	$875,855.37
Net gain from operations before Federal Income Taxes	$1,525,357.72
Federal Income Taxes incurred	377,217.70
NET GAIN FROM OPERATIONS	$1,148,140.02

Surplus Account

Unassigned surplus December 31, 1963	$3,073,910.96
Net gain	1,148,140.02
Surplus paid in	32,079.25
Total	$4,254,130.23
Net Capital Lossess	$32,079.25
Net loss from non-admitted items	2,203.93
Increase in Mandatory Securities Valuation reserve	14,435.35
Unassigned surplus Dec. 31, 1964	4,205,351.70
Total	$4,254,130.23

Premiums and Annuity Considerations Gross Less Reinsurance Ceded

Renewal:	*Total*
Uncollected	$400,711.50
Deferred	979,300.00
Collected during year	6,148,353.30
Less previous year	671,377.82
Total Premiums	$6,847,986.98
Commissions incurred:	
Renewal	$786,750.91
Total	$786,750.91
Net investment income:	
Gross investment income	$153,461.43
Investment expenses	14,090.91
Net investment income	$139,370.52
Ratio of net investment income to means assets	2.50%

Gross Investment Income

	Collected during year	Due and accrued 12/31/64	Due and accrued 12/31/63	Earned during year
Interest on bonds	[1] $118,349.88	$39,599.67	$14,905.32	$143,044.23
Dividends on stock	10,148.61	0	0	10,148.61
Interest on bank deposits	826.64	0	558.05	268.59
Totals	$129,325.13	$39,599.67	$15,463.37	$153,461.43

[1] Includes $7,547.32 accrual of discount less $39.34 amortization of premium and less $4,035.56 paid for accrued interest of purchases.

Capital Gains and Losses on Investments

	Net loss from change in diff. between book and admitted values	Net losses
Stocks	$32,079.25	$32,079.25
Totals	$32,079.25	$32,079.25
Less federal income tax incurred on capital gains		0
Net unrealized capital losses		$32,079.25

General Expenses

	Insurance			
	Life	Accident and health	Investment	Total
Rent	$2,531.70	$2,288.30		$5,820.00
Salaries and wages	33,037.31	42,910.53		75,947.84
Fees of public accountants	728.62	946.38		1,675.00
Traveling expenses	481.26	625.09		1,106.35
Postage, express, tele., and telegraph	1,382.99	1,796.29		3,179.28
Printing and stationery	1,742.87	2,261.14		4,002.01
Cost of dep. of furniture and equipment	865.11	1,122.65		1,988.76
Books and periodicals	232.70	302.24		534.94
Bureau and association dues	62.86	81.64		144.50
Sundry general expenses	51.26	66.50		117.86

General Expenses—Continued

	Insurance			
	Life	Accident and health	Investment	Total
Gp. services and admin. fees	39,481.30	35,784.86		75,266.16
Donations	180.52	234.48		415.00
Entertainment expense	327.60	425.51		753.11
Transfer to investment expense	(6,129.55)	(7,961.36)	$14,090.91	
General expenses paid	$74,974.55	$81,855.34	$14,090.91	$170,950.80
Gen. exp. unpaid 12-31-64	15,875.00	52,846.95	0	68,721.95
Gen. exp. unpaid 12-31-63	797.13	877.87	0	1,675.00
Gen. exp. incurred during year	$90,052.42	$133,854.42	$14,090.91	$237,997.75

Taxes, Licenses and Fees

	Insurance		
	Life	Accident and health	Total
Ins. Dept. licenses and fees	$2,898.29	$3,764.44	$6,662.73
Other state taxes	164.60	213.78	378.38
U.S. Social Security taxes	512.57	665.76	1,178.33
All other taxes	38.28	49.71	87.99
Taxes, licenses and fees paid	$3,613.74	$4,693.69	$8,307.43
Taxes, lic. and fees unpaid 12-31-64	2,038.74	3,058.10	5,096.84
Taxes, lic. and fees unpaid 12-31-63	85.93	94.63	180.56
Taxes, licenses and fees incurred	$5,566.55	$7,657.16	$13,223.71

Dividends to Policyholders

	Life	Acc. and health
Paid in cash	$482,642.51	$129,512.86
Prov. for dividends payable in following year. Not yet apportioned	239,300.00	24,400.00
Total dividends to policyholders	$721,942.51	$153,912.86

Reconciliation of Ledger Assets

Increase in ledger assets:		
Premiums on life policies		$2,965,045.43
Accident and health premiums		3,183,307.87
Gross investment income		129,325.13
Surplus paid in		32,079.25
Total Increase		$6,309,757.68
Decrease in ledger assets:		
Policy and contract claims:		
Life	$1,191,805.16	
Accident and health	1,694,810.95	
Group conversions	1,495.00	
Dividends to policyholders:		
Life	482,642.51	
Accident and health	129,512.86	
Total Paid Policyholders		$3,500,266.48
Commission to agents		
Life	$390,707.37	
Accident and health	486,312.59	877,019.96
General expenses		170,950.80
Tax, licenses & fees (excl. Fed Income Tax)		8,307.43
Federal Income Taxes		534,786.02
Total Decrease		$5,091,330.69
Reconciliation between years:		
Ledger assets December 31, 1963		$4,002,876.41
Increase in ledger assets during year		1,218,426.99
Total: Ledger assets December 31, 1964		$5,221,303.40

Assets

	Ledger Assets	Non-ledger Assets	Not Admitted Assets	Net Admitted Assets
Bonds	$4,087,581.71			$4,087,581.71
Stocks	162,079.25		$32,079.25	130,000.00
Cash and bank deposits	362,097.90			362,097.90
Reinsurance premiums receivable		$1,371,011.50		1,371,011.50
Furniture and equipment	9,544.54		9,544.44	0
Interest due and accrued		39,599.67		39,599.67
Totals	$5,221,303.40	$1,410,611.17	$41,623.79	$6,500,290.78

Analysis of Non-Admitted Assets

	12/31/63	12/31/64	Change for the year
Furniture and equipment	$7,280.61	$9,544.54	−$2,263.93
Total change			−$2,263.93

ASSETS

Bonds, $4,687,581.71

Bonds owned by the Company as of December 31, 1964, having a book value as shown above, represented 71.1% of the total admitted assets. Government bonds with a par value totaling $606,000.00 were on deposit with the Missouri Division of Insurance and were verified by direct correspondence. Additional government bonds owned by the Company at December 31, 1964, with a par value totaling $1,850,000.00 were verified through the inspection of an official certificate of deposit approved by your Division on September 7, 1965. The remainder of the Company's bonds consisting of Treasury bills maturing in 1965 were verified by checking and inspecting applicable records of cash receipts including bank deposit slips.

Each bond was eligible for amortization, and the scientific method was used in computing the amortization of premiums and the accrual of discount. The Company's computations were found to be accurate. Adjustments for amortization were made annually to the general ledger control account for bonds.

The following schedule classifies the Company's investment in bonds as of December 31, 1964:

	Cost	Par Value	Book and/or Amort. Value
U.S. Government			
Treasury bonds	$2,409,398.46	$2,450,000.00	$2,429,577.04
Treasury bills	2,252,004.67	2,300,000.00	2,252,004.67
Savings bonds	6,000.00	6,000.00	6,000.00
Total	$4,667,403.13	$4,756,000.00	$4,687,581.71

The following reconciliation summarizes the Company's bond transactions for the period from October 1, 1961, through December 31, 1964:

	10-1-61 through 12-31-61	1962	1963	1964
Bk. Val. Beginning of year	$844,966.90	$1,132,770.69	$1,776,484.72	$2,827,346.45
ADD:				
Cost of bonds acquired	430,851.57	1,331,477.31	3,174,938.47	5,956,551.56
Profit on sales	0	0	0	0
Increase by adjustment	7,285.70	12,579.45	8,626.66	7,547.32
Subtotal	$1,283,104.17	$2,476,827.45	$4,960,049.87	$8,791,445.33
DEDUCT:				
Consideration on sales	150,000.00	700,000.00	2,132,348.58	4,103,824.28
Loss on sales	0	0	0	0
Decrease by adjustment	333.48	342.78	354.84	39.34
Book Value End of Year	$1,132,770.69	$1,776,484.72	$2,827,346.45	$4,687,581.71

Accrued interest on bonds as of December 31, 1964, as computed by the Company and verified during the course of this examination was $39,599.67 which amount has been included among the non-ledger assets on the balance sheet of this report. Interest received was tested and found to be correct as reported.

Acquisitions and disposals of bonds were checked through the accounting system into source records, and no discrepancies were noted. All investments were approved at the annual meetings of the shareholders.

The rate of earnings on bonds based on the mean book value is set out in the following exhibit:

Mean book value	$988,868.80	$1,454,627.71	$2,301,915.54	$3,757,464.08
Interest earned	30,438.68	56,063.50	80,435.43	142,044.23
Rate of earnings	3.078%	3.854%	3.494%	3.8335%

Stocks, $130,000.00

The captioned amount represents the Company's investment in 13 savings and loan associations in the amount of $10,000.00 each as of December 31, 1964. Verification was accomplished by direct correspondence with the savings and loan associations. Dividends received for the period under

review were checked comprehensively and were found to be correct as reported on the annual statements.

In addition to the above captioned amount, the Company had common stocks of various subsidiary Aetna Finance Companies in its portfolio as of the examination date. These stocks were contributed to the Company by the ITT Aetna Finance Company, assigned an arbitrary value of $1.00 per share for a total book value of $32,079.25 but also shown as an asset not admitted in the same amount thereby refraining from taking any credit as an admitted asset on the annual statement. This identical treatment has been followed for this report because the stocks are not listed in the N.A.I.C. *Valuation of Securities as of December 31, 1964* and appear to represent minority holdings of stocks not publicly traded.

The following reconciliation summarizes the Company's transactions in stocks and savings and loan shares for the period from October 1, 1961, through December 31, 1964:

	10-1-61 through 12-31-61	1962	1963	1964
Book Value Beginning of period	$0	$0	$0	$500,000.00
Add:				
Cost of stocks acquired	0	0	1,000,000.00	32,709.25
Profit on sales	0	0	0	0
Increase by adjustment	0	0	0	0
Sub-Total	$0	$0	$1,000,000.00	$532,709.25
Deduct:				
Considerations on sales	0	0	500,000.00	370,000.00
Loss on sales	0	0	0	0
Decrease by adjustment	0	0	0	0
Book Value End of Period	$0	$0	$500,000.00	$162,709.25

The rate of earnings based on the monthly mean book value is shown in the following exhibit:

	10-1-61 through 12-31-61	1962	1963	1964
Mean book value	$0	$0	$250,000.00	$205,833.00
Dividends received	0	0	34,457.04	10,148.61
Rate of earnings	0	0	4.864%	4.934%

Cash and Bank Deposits, $362,097.70

At December 31, 1964, the Company had deposits in 7 banks and trust companies aggregating the above amount.

Certificates of deposits were obtained from each depository certified to by an official of each, and reconciled to the Company's general ledger after allowing for outstanding checks and deposits in transit as of December 31, 1964.

Interest received in the amount of $826.64 as reported by the Company at December 31, 1964, was found to be correct.

Reinsurance Premiums Receivable, $1,371,011.50

This non-ledger asset comprising 20.8% of the total admitted assets, represents the net premiums due from ceding insurance companies as of December 31, 1964, and is classified as follows:

	Life	A&H	Total
Due Nov. 30, 1964	$14,026.31	$16,786.03	$30,812.34
Due Dec. 31, 1964	715,225.96	624,973.20	1,340,199.16
Total	$729,252.27	$641,759.23	$1,371,011.50

Monthly reports from the ceding insurance Companies showing the net premiums due were reconciled to the premium receipts from these Companies received in 1965 and were verified correct as reported.

Interest Income Due and Accrued, $39,599.67

The item comprising this amount representing interest due on bonds is commented upon in the prior section of this report.

LEDGER ASSETS NOT ADMITTED

Furniture and Equipment, $9,544.54

Expenditures for furniture and equipment were traced and checked to paid invoices for the period under review. No errors were noted.

LIABILITIES

Aggregate Reserve for Life Policies, $306,698.00

The valuation standard for the above capitioned life reserves was: 1941 CSO 2% NL.

A certification of the Company's reserves was obtained from its consulting actuaries. A copy of the certification has been included as an attachment to this report.

Aggregate Reserve for Accident and Health Policies, $59,673.48

The captioned amount includes the unearned premium reserve of $39,673.48 for group accident and health, computed by the rule of 78 and a provision of $20,000.00 for present value of amounts not yet due on claims. The certification by the consulting actuaries has been reproduced and attached to this report.

Policy and Contract Claims, $902,602.85

Life	*$300,309.20*
Accident and Health	*$602,293.65*

The above amount represents the total liability for benefits under policies determined by this examination and is classified as follows:

	In Course Of Settlement	Incurred but Not Reported	Total
Life	$243,048.26	$57,260.94	$300,309.20
Accident and Health	455,954.58	146,339.07	602,293.65
Total	$699,002.84	$203,600.01	$902,602.85

As stated in the forepart of this report, the Company assumes all of its group and individual life and accident and health insurance in accordance with the terms of the reinsurance contracts involved. Compensation for all life and

accident and health claims to the insured is paid by the ceding Companies for benefits provided for as shown in the policies issued to the insured. Monthly reports furnished by the ceding companies showing the amount of claims paid by them and the monetary amount due them were examined and found to be in accordance with the terms of their respective reinsurance contracts.

All ceding companies submit monthly reports of claims due them with the exception of the Equitable Life Assurance Society of the United States, New York, New York, which submits an annual report as of July 31st of each year for the monetary amount of the settlement according to the reinsurance agreement. In addition, for annual statement purposes, the Equitable Life Assurance Society submits to the Company a report of the Company's share of the claim liability for both life and accident and health claims, as of December 31, 1964. The entire amount shown by Equitable is reported as in course of settlement, on their statement to the Company aggregating $207,000.00 for life claims and $448,473.65 for accident and health claims, and is reported as such in the financial statement of this report.

The liability for incurred but not reported claims as reported by the Company and as determined by this examination as of December 31, 1964, is reflected as follows:

	Per Company 12/31/64	Per Examination 12/31/64	Diff Per Examination
Life:			
Individual	$66,013.47	$57,260.94	−$8,752.53
Group	0	0	0
Accident and Health:			
Individual	56,479.86	101,080.75	+44,600.89
Group Maj. Med.	45,258.32	45,258.32	0
	$167,751.65	$203,600.01	+$35,848.36

The amount shown by the Company at December 31, 1964, was arrived at by the use of a formula, based on past experience taking the claim payments for the first 15 days of January, 1965, and multiplying this amount by 3, plus an additional 10% of the developed amount for accident and

health claims. Your examiners, however, increased this liability in the net amount of $35,848.36 by using the actual amount of claims paid for the period of January 1 through August 31, 1965, on claims incurred during 1964 and not reported until 1965.

No claim files were available for review as all claims are processed, settled and/or closed by the ceding companies. Paid claim vouchers of the Company were reconciled to monthly reports of claims due from the ceding insurance companies involved to determine the amount of claims paid. No errors were noted.

The liability for the incurred but unreported claims on group major medical insurance was developed by a formula, promulgated by Nelson and Warren, Inc., consulting actuaries for the Company, which was considered adequate for the settlement of any and all claims that might occur under these policies.

Provision for Policyholders' Dividends Payable in Following Calendar Year, $263,700.00

The captioned liability was taken from the statement furnished to the Company by the Equitable Life Assurance Society of the United States, New York, New York. The statement covered experience from August 1, 1964, to December 31, 1964, and pertained to dividends for group insurance on employees of the International Telephone and Telegraph Corporation. The dividends are classified as follows:

Life	$221,600.00
AD and D	17,700.00
Weekly Indemnity	1,400.00
Hospital	23,000.00
Total	$263,700.00

Commissions to Agents Due or Accrued, $123,845.20

The above amount, as reported by the Company at December 31, 1964, was verified correct from reports furnished by ceding Companies showing the amount of commissions due them in accordance with their reinsurance contracts.

General Expenses Due or Accrued, $68,721.95

The major portion of the captioned liability represents $66,525.00 comprised of group administration fees accrued

on the group business reinsured from the Equitable Life Assurance Society of the United States as reported on Equitable's year end statement to the Company. The remainder of the liability is comprised of actuarial fees and other expenses of a general nature incurred in 1964 and paid in 1965 with verification achieved by inspection of records of cash disbursements.

The group administration fees were classified according to lines of business as follows:

Life	$12,600.00
AD and D	3,175.00
Weekly indemnity	1,400.00
Hospital	49,350.00
Total	$66,525.00

Taxes, Licenses and Fees Due or Accrued, $5,096.84

The above liability consisted of the following items due and unpaid at December 31, 1964:

Premium taxes	$2,615.22
Occupational taxes	1,176.50
License fees	580.00
New business forms	725.12
Total	$5,096.84

All other liabilities that normally appear under this account were disposed of due to the method of accounting whereby the books are left open for several days at the year end so that many incurred items may be accounted for without the necessity of accruals. The capitioned liability was established through the inspection of a reinsurance report of the Pilot Life Insurance Company which report reflected the items described above and pertained to 1964 business assumed by the Company.

Federal Income Taxes Due or Accrued, $21,787.70

The Federal Income Tax return for the year ending December 31, 1964, together with the canceled check payable to the Internal Revenue department substantiated the above liability.

Mandatory Securities Valuation Reserve, $32,813.06

In accordance with the various resolutions passed by the National Association of Insurance Commissioners, the Com-

pany includes among its liabilities the "Mandatory Securities Valuation Reserve" computed by formula promulgated by the Committee on Valuation of Securities. The Company's computations were checked for each of the years under review and found to be correct as reported.

Capital Stock, $100,000.00

As of December 31, 1964, the Company's authorized and outstanding capital stock amounted to $100,000.00 consisting of 100,000 shares with a par value of $1.00 each and owned in its entirety by the ITT Aetna Finance Company. The capital stock was increased during the course of the examination to $1,000,000.00 consisting of 1,000,000 shares paid for by transfer of $900,000.00 from unassigned surplus to the capital stock account.

ACKNOWLEDGMENT

The assistance and cooperation of the officers and employees of the Company during the course of this examination is hereby acknowledged.

In addition to the undersigned, the following examiners of the Missouri Division of Insurance participated in the examination and in the preparation of this report: Dennis L. Knipp, Don G. Cowsert.

Respectfully submitted,

(Signed) Preston D. Allison

PRESTON D. ALLISON,

Examiner, Division of Insurance, State of Missouri.

NELSON AND WARREN, INC.,
CONSULTING ACTUARIES,
SAINT LOUIS, MO., *September 17, 1965.*

MR. PRESTON D. ALLISON: As Consulting Actuaries who aided in the preparation of the December 31, 1964 Financial Statement of American Universal Life Insurance Company, we affirm that we determined the policy reserves listed below, and that the amounts thereof were computed in accordance with the terms of the outstanding policies and the Insurance Code of the State of Missouri, and that, based upon the records of the Company furnished to us, they are

a true statement of the reserve liabilities of the Company as of December 31, 1964.

1. Aggregate reserve for life policies	$806,698.00
2. Aggregate reserve for A. & H. policies	59,673.48

NELSON AND WARREN, INC.,
By E. DEAN FORBES, (sgd)

St. Louis, Missouri.

ANALYSIS OF CHANGE IN SURPLUS

The unassigned surplus as developed by this examination is $41,062.15 less than reported in the Company's 1964 Annual Statement.

An analysis of this difference is reflected in the folowing schedule.

	Change in surplus		
	Increase	Decrease	
Assets			
No change	$0	$0	
Liabilities			
Policy and contract claims			
Life	8,752.53		
Accident & Health		44,600.89	
General expenses due or accrued		116.95	
Taxes, Lic. & Fees due or accrued		5,096.84	
Totals	$8,752.53	$49,814.68	$41,062.15
Unassigned surplus per Examination December 31, 1964			4,246,413.85
Unassigned surplus per Examination December 31, 1964			$4,205,351.70

EXHIBIT 25

REPORT OF EXAMINATION

ITT HAMILTON LIFE INSURANCE COMPANY

Clayton, Missouri, December 31, 1968

REPORT OF EXAMINATION

ITT HAMILTON LIFE INSURANCE COMPANY

Clayton, Missouri, December 31, 1968

Under Authority of National Association of Insurance Commissioners

States Participating: California, Maryland, Missouri, and Wyoming

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St. Louis, Missouri, June 20, 1969.

Honorable ELMER V. OMHOLT
Commissioner of Insurance
Chairman of Committee on Examinations, N.A.I.C.
Chairman, Zone 6, N.A.I.C.
Helena, Montana 59601

Honorable ROBERT A. SHORT
Insurance Commissioner
Chairman, Zone 2, N.A.I.C.
Dover, Delaware 19901

Honorable WILLIAM Y. MCCASKILL
Superintendent of Insurance
Chairman, Zone 3, N.A.I.C.
Jefferson City, Missouri 65101

Honorable BENJAMIN C. NEFF, Jr.
Director of Insurance
Chairman, Zone 5, N.A.I.C.
Lincoln, Nebraska 68509

SIRS: Pursuant to the requirement of statute and in conformity with your several certificates of authority, an examination has been made of the financial condition, affairs and management of the ITT HAMILTON LIFE INSURANCE COMPANY at its Home Office situated at 212 South Central Avenue, St. Louis, Missouri, 63105. This examination which commenced March 10, 1969, was completed on the above captioned date of this report, which is herewith respectfully submitted.

SCOPE OF EXAMINATION

The examination of the ITT Hamilton Life Insurance Company, hereinafter referred to as such or as the "Company" was conducted by the Missouri Division of Insurance under the plan adopted by the National Association of Insurance Commissioners with participation by examiners from the States of Maryland, Wyoming and California representing Zones II, V, and VI respectively. The last examination of the Company was made by the Missouri Division of Insurance as of December 31, 1964, and the cur-

rent examination covers the intervening period to the close of business on December 31, 1968.

The examination was made in accordance with generally accepted standards, during the course of which, the transactions of the Company were reviewed and tested by methods deemed adequate and appropriate, including a review of general operations, treatment of policyholders, investment policy and financial condition.

Explanation of and details pertaining to the various phases of the examination will be found under the subjects hereinafter set forth.

HISTORY—OBJECTS—GROWTH

History

The company, incorporated under the laws of Missouri on August 8, 1955, as a stipulated premium company, was licensed September 22, 1955 and commenced business October 1, 1955 under the name American Universal Life Insurance Company. The company changed its name to ITT Life Insurance Company on October 3, 1966 and subsequently changed its name to ITT Hamilton Life Insurance Company on August 24, 1967. Initial resources of $50,000 (capital $25,000 and surplus $25,000) were provided through the sale of 100 shares of common stock, par value $250, at $500 per share. On September 6, 1957, the company was converted from a stipulated premium company to a legal reserve life company.

As part of the reorganization, the authorized capital stock was increased to $100,000, comprising 100,000 shares of common stock, par value $1. Each of the outstanding shares, par value $250, was exchanged for 1,000 shares of the new $1 par value stock. A stock dividend of $900,000 (900%) in September, 1965 raised capital to $1,000,000. In January, 1966, a contribution surplus of $2,080,349 was made which comprised all the outstanding stock of the Alexander Hamilton Life Insurance Company, Denver, Colorado. At year end 1967, Alexander Hamilton Life was

absorbed by merger. Present authorized capital is 1,000,000 shares of common stock, par value $1, all of which are issued and outstanding.

In December, 1967, the Company purchased control of Modern Life Insurance Company, New York, and at 1967 year end owned about 98% of the shares of Modern Life, which changed its name to ITT Life Insurance Company of New York on April 1, 1968.

Documents as regards the increase of capital stock from $100,000 to $1,000,000 on September 7, 1965; the change in name to ITT Life Insurance Company on October 3, 1966, and the subsequent change to ITT Hamilton Life Insurance Company on August 24, 1967, were submitted to and received approval of the Secretary of State as well as the Superintendent of Insurance of Missouri, as required by statutes.

The contribution to the Company's surplus of $2,080,349 representing all of the outstanding capital stock of the Alexander Hamilton Life Insurance Company, was approved by the Superintendent of Insurance of Missouri in accordance with Section 375.355 of the Missouri Insurance Statutes relating to "Acquisition of control of one company by another." Prior to the contribution this stock was held in the name of the ITT Aetna Finance Company, a Delaware corporation.

In the merger of the Alexander Hamilton Life Insurance Company, a Delaware corporation, with Administrative Offices in Denver, Colorado, the assets received and the liabilities assumed by the Company were as follows:

	Assets received	Liabilities assumed	
Bonds	$528, 499	$1, 050, 626	Life reserves
Stocks	232, 964	3, 379	A & H reserves
Mortgage loans	62, 877	38, 611	Life claims
Policy loans	1, 185	82	A & H claims
Cash & bank deposits	1, 818, 803	6, 392	Prems. paid in advance
Due from reinsurers	12, 377	4, 266	Prem. deposit funds
Uncoll. & Def. life prems.	449, 214	26, 453	Commissions to agents
A & H prems. due & unpaid.	(88)	32, 487	Unpaid expenses

	Assets received	Liabilities assumed	
Inv. income due & accrued.	$28, 908	$36, 670	Taxes, licenses & fees
		2, 547	Amts. held for others
		5, 039	Remitts. not allocated
		1, 917	Mandatory security val. res.
		1, 926, 270	Assets in excess of liabilities
Totals	$3, 134, 739	$3, 134, 739	

Assets in excess of liabilities to the extent of $1,926,270 represents the book value (capital plus surplus) of the Alexander Hamilton Life Insurance Company, Denver, Colorado, at December 31, 1967, which at the time it was contributed in January 1966, was worth $2,080,349.

As required by Section 376.520 of the Missouri Insurance Statutes, the merger was approved by a three-way commission consisting of the insurance supervisory authorities of the States of Illinois, Missouri and Ohio. In addition a "certificate of assumption" was mailed to each policyholder of the Alexander Hamilton Life Insurance Company at the time the merger was completed.

Objects

The principal purposes for which the Company was formed as set out in its amended Articles of Incorporation, are as follows:

> "To make insurance upon the lives of individuals and every assurance pertaining thereto or connected therewith; to grant, purchase, and dispose of annuities and endowments of every kind and description whatsoever; to provide for contracts of indemnity against death and for weekly and other periodic indemnities for disability occasioned by accident or sickness to the person of the insured, and such accident and health insurance shall be made a separate department of the business of the corporation, and for the reinsurance of any of the foregoing;

and to do such other things as may be permitted a corporation of this kind by law, and not prohibited by the 1949 Revised Statutes of Missouri, Sections 376.010 to 376.670, both inclusive, as amended. The corporation may issue participating and non-participating policies or contracts, provided that any participating policy or contract shall give the right to participate in the divisible surplus earnings of the company as provided by law and more particularly as provided by Sections 376.360 and 376.370 of the 1949 Revised Statutes of Missouri, as amended."

Growth

Following is a schedule, in condensed form, setting forth pertinent data respecting the Company's trend from operations during the period under examination:

Year	Life insurance in force	A&H premiums written	Capital paid-up	Admitted assets	Surplus as regards policyholders
1964.....	$221,383,507	$3,183,308	$100,000	$6,590,201	$4,246,414
1965.....	253,814,053	4,099,259	1,000,000	13,720,593	4,220,593
1966.....	309,210,582	4,850,877	1,000,000	15,855,639	7,537,375
1967.....	474,348,889	6,080,775	1,000,000	15,112,657	4,588,451
1968.....	749,087,417	8,021,746	1,000,000	19,550,833	5,417,535

The sharp decrease in surplus as regards policyholders during 1967 of $2,948,924, can be attributed chiefly to the Company's purchase of over 95% of the capital stock of the Modern Life Insurance Company of New York, later renamed ITT Life Insurance Company of New York, which was acquired at a cost of $5,309,991. This stock had to be valued at book (Capital plus surplus) amounting to $1,704,479, as prescribed in Section 4, Procedures for valuing other securities, of the N.A.I.C. Book of Valuations of Securities, which accounts for large unrealized capital loss effecting surplus during 1967.

The purchase of the aforedescribed stock received the approval of the Superintendent of Insurance of Missouri, as required by Section 375.355 of the Missouri Insurance Statutes relating to "Acquisition of control of one company by another." A quarterly financial statement of the Modern Life Insurance Company as of June 30, 1967, filed with the

Superintendent of the New York Insurance Department was presented at this hearing.

As respects the purchase of the capital stock of the Modern Life Insurance Company of New York, the Company was required to execute a "Commitment Agreement" with the New York Insurance Department. Generally, under the terms of this agreement there can be no inter-locking transactions between the companies without the approval of the New York Insurance Department and the ITT Life Insurance Company of New York agrees to operate at arm's length in relation to the ITT Hamilton Life Insurance Company, its subsidiaries and affiliates.

At the time of the aforementioned purchase all of the outstanding capital stock of the Company was registered in the name of the ITT Aetna Corporation of New York.

MANAGEMENT

The Company is wholly owned by ITT Aetna Corporation, a New York corporation which, in turn, is a subsidiary of the International Telephone and Telegraph Corporation of New York.

Operations are conducted on the proprietary plan and academically the Company's corporate powers are vested in and exercised by a Board of Directors, consisting of twelve members, elected annually by the stockholders. Following each annual meeting of stockholders, the Directors convene for the purposes of organization and the appointment of officers and committee members who, according to the by-laws, are charged with the active management of the Company's affairs.

Directors, committee members and officers duly elected and serving December 31, 1968, were as follows:

Board of Directors

Name	Principal Business Affiliations	Residence
Joseph Kutten	Board Chairman and Chief Executive Officer of the Company.	Ladue, Mo.
Howard T. Cohn	Vice President and Actuary of the Company and Vice President of the ITT Financial Services Inc.	Madison, N.J.

Board of Directors—Continued

Name	Principal Business Affiliations	Residence
David R. Corwin	President, ITT Aetna Corporation	Chesterfield, Mo.
Gerhardt M. Hoff	Director of Insurance Operations of ITT Financial Services Inc.	New York, N.Y.
Dean L. Hones	Vice President of the Company	Littleton, Colo.
Gerald M. Kantor	Vice President and Treasurer of the Company.	St. Louis County, Mo.
John H. Kostmayer	Director, ITT Financial Services Inc.	Solebury, Pa.
Claude J. Peay	Vice President of the Company and Vice President, Hamilton Management Corporation.	Denver, Colo.
Frank H. Peirson	President of the Company and President of Hamilton Management Corporation.	Englewood, Colo.
Robert B. Schneider	Secretary of the Company	St. Louis, Mo.
James C. Swain	Senior Vice President of the Company and Vice President of the Hamilton Management Corporation.	Arvada, Colo.
Joseph R. Tirone	Vice President of the Company and Vice President & Comptroller of Hamilton Management Corporation.	Denver, Colo.

EXECUTIVE COMMITTEE

Howard T. Cohn
David R. Corwin
Gerhardt M. Hoff
Joseph Kutten
Frank H. Peirson
James C. Swain

John H. Kostmayer, Acting Chairman

Officers

Name	Title	Annual compensation (1968)
Joseph Kutten	Board Chairman and Chief Executive Officer	$45,000
Frank H. Peirson	President	0
James C. Swain	Senior Vice President	0

Officers—Continued

Name	Title	Annual compensation (1968)
Howard T. Cohn	Vice President & Actuary	0
Dean L. Hones	Vice President	0
Gerald M. Kantor	Vice President & Treasurer	$19, 800
Claude J. Peay	Vice President	0
Warren J. Schulte	Vice President	17, 100
Joseph R. Tirone	Vice President	0
Robert B. Schneider	Secretary	17, 200

The Company states that officers to which no compensation was paid during the year 1968, were remunerated directly by the International Telephone and Telegraph Company, its subsidiaries or affiliates.

Aside from actual expenses incurred, no officers or member of the Board of Directors, salaried or otherwise, receive a fee for actual attendance of this corporate body.

Annual meetings of stockholders as well as the Board of Directors are held on the second Tuesday in March of each year. Special meetings are upon call by one-fifth (1/5) or more of the outstanding stock in the case of shareholders and a majority of the members are necessary at any meeting of the Board of Directors.

Signed minutes of the meetings of all corporate bodies held during the period under examination were reviewed. These records indicate good attendance and the shares of stocks represented by the parent company were always voted en bloc by a duly authorized attorney-in-fact.

There were a number of changes made in the Articles of Incorporation and By-laws during the period under review. The most important of these, which are not commented upon elsewhere in this report was the increase in the Board of Directors from nine (9) to twelve (12) members.

To guard against any conflict of interest the Company requires its Officers and Directors to execute a signed statement containing the following quoted questions:

> 1. Do you or does any member of your family have any relationships or engage in any activities that

might impair your independence of judgment concerning Company business?

2. Do you or does any member of your family have any personal financial interests that might impair your independence or judgment or influence your decisions or actions concerning Company business in the direction of such personal financial interests?

3. Have you accepted gifts, benefits, or unusual hospitality that might tend in any way to impair your independence of judgment or affect your decisions or actions concerning Company business?

(If your answer to any of the foregoing three questions is "yes", please attach to this questionnaire a full explanation.)

Officials stated they have no record in the history of the Company of any of its members having been involved in a conflict of interest case.

The business affairs of the Company's Denver, Colorado office are administered under the terms of a management contract. Further explanation concerning this are contained in "General Comments", appearing in the concluding pages of this report.

FIDELITY BONDS AND OTHER INSURANCE

The Company is a named assured in a number of policies issued to its parent Company, International Telephone and Telegraph Corporation of New York, affording protection as follows:

Comprehensive General—Automobile Liability Insurance, Limit of Liability—Combined Single Limit, $2,000,000.00 "Each Accident"

A—Bodily Injury Liability—Automobile (Owned-Non-Owned) Property Damage Liability

B—Bodily Injury Liability—Except Automobile Property Injury Liability—Except Automobile

C—Personal Injury Liability

D—Malpractice—Physicians and Nurses employed by the insured

E—Assault and Battery

In addition the above policy also provides the following Coverages:

1—Products Liability—Aircraft Products
2—Private Heliport
3—Contractual Liability Coverage
4—Airport Liability
5—Personal Liability Coverage for Executive Officers (Limit $200,000.00 Liability and $250.00 Medical and is applicable only outside of United States, its Territories, Possessions, and Canada)

Blanket Crime Policy:

Liability $2,000,000.00; Deductible $5,000.00
1—Loss of money, securities and other property through fraudulent and dishonest acts of employees
2—Loss Inside Premises Coverage (Banking premises covered)
3—Loss Outside Premises Coverage
4—Money Orders and Counterfeit Paper Currency Coverage (if not paid upon presentation)
5—Depositors Forgery Coverage
6—Credit Card Forgery Coverage—Shall not exceed, in the aggregate, $10,000.00 (Deductible not applicable)

In addition to the above policies ITT Hamilton Life Insurance Company is protected by a "Burglary Policy" covering the Loss of Securities deposited with the First National Bank in St. Louis, St. Louis, Missouri, in the amount of $2,000,000.00.

The foregoing policies were inspected and found to be carried through authorized insurers in Missouri.

EMPLOYEE BENEFIT AND WELFARE PLANS

Group life and hospitalization insurance is provided for the employees of the Company. Under the group life policy, death benefits range from $2,000.00 to $10,000.00. The amount of insurance is determined by the employees' basic annual salary and is approximately one year's salary with an

equal amount for accidental death and dismemberment. The policies are non-contributory as regards the employees, the Company assuming the entire cost. The group hospitalization policy provides benefits for room and board charges, special hospital services and additional medical expenses for surgical bills, doctor bills and related charges. It is a comprehensive medical plan which is non-contributory for employees and contributory in part for dependents.

During the latter part of 1968, provisions were made for the salaried employees of the Company to participate in the International Telephone Retirement Plan. The Company is a wholly-owned subsidiary of International Telephone and Telegraph Corporation. The participation effective retroactively as of January 1, 1968. The cost of providing benefits under the plan is paid entirely by the Company and no contributions are required from the employees. All salaried employees on January 1, 1968 and who were less than age sixty-five on that date automatically became members of the plan as of January 1, 1968. All eligible salaried employees hired after January 1, 1968 who are younger than age fifty-five at date of employment automatically become members when they complete three years of service or reach age thirty, if earlier.

Normal retirement age under the plan is sixty-five. However, an employee can elect to retire on the first day of any month between age fifty-five and sixty-five, provided he has at least ten years of credited service and the Company approves.

The Company's contributions to the plan go into a trust fund managed by a Plan Trustee, according to the terms of a trust agreement. This money is invested by the Trustee and is used to provide benefits for the members and their beneficiaries.

TERRITORY AND PLAN OF OPERATIONS

As of December 31, 1968 the Company was authorized to transact the business of insurance in the District of Columbia, Guam, Puerto Rico, and in all states except Connecticut, New Jersey and New York, as evidenced by Certificates of Authority from the various jurisdictions. With the exception of Missouri, the Company was admitted to do business in

the various jurisdictions during the four year period under examination.

The Company's ordinary operations are conducted on the general agency plan through approximately 2,600 agents, a majority of whom are also representatives of Hamilton Management Corporation (independent sales force distributors of Hamilton Funds, Inc., a mutual fund). The entire ordinary operations are maintained at the Company's Denver, Colorado office.

Group operations including all credit business are conducted at the Company's home office. Group life and accident and health business is generated through seven group sales offices. Credit life and accident health business is written primarily through approximately 260 ITT Aetna Finance offices.

POLICY FORMS AND UNDERWRITING PRACTICES

The Company writes whole life, limited payment life, family income, and level and decreasing term insurance on an individual or on a joint basis. Riders which may be attached to policies include waiver of premium, accidental death and level and decreasing term insurance. The Company also issues group life and group accidental and health policies. Credit life and credit accident and health insurance are written on a group contract in most states.

All of the Company's ordinary business are nonparticipating.

Prior to April 1, 1968, the Company's maximum limit of retention on any one life was $25,000 with a corridor of $10,000 on life insurance, and $10,000 for accidental death benefits. Effective April 1, 1968, the maximum retention was increased to $50,000 with a corridor of $10,000 on life insurance, with the accidental death benefits remaining at $10,000.

The Company's underwriting rules regarding non-medical limits is shown in the following schedule:

Ages:	*Amount*
0 to 5	$20,000
6 to 28	50,000
29 to 35	20,000
36 to 40	10,000

The Company's method of recording approval of its forms by the various states in which it is licensed was reviewed, as well as correspondence with various insurance departments relating to the approval of a sampling of policy forms used by the Company. The method used appears to be adequate.

REINSURANCE

Ceded

At December 31, 1968 the Company had in force two automatic reinsurance agreements covering its ordinary life business with two companies admitted in the State of Missouri. One agreement applies to ordinary business where the insured's last name falls in the range "A to K", and the other agreement applies to ordinary business in the "L to Z" range. Under the agreements the Company agrees to cede and the reinsurers agree to accept ordinary business in excess of the following retention limits:

Age	Standard	Substandard (to table 16)
0 to 80	$50,000	$50,000

(The above may be exceeded by amounts less than $10,000 to avoid reinsurance.) Accidental death (D.I.)—All ages, all tables—$10,000.

The first reinsurer (A to K) automatically accepts up to four times the Company's retention on ages 0 to 60 and twice the Company's retention on ages 61 to 80, and up to $90,000 on accidental death benefit.

The second reinsurer (L to Z) accepts up to four times the Company's retention for all ages, and up to $50,000 on accidental death benefit.

In order to protect itself against excessive losses on group policies, the Company had in effect the following reinsurance agreements: an automatic agreement on group life and accidental death and dismemberment; quota share agreement on group long term disability; and a combination

quota share and first surplus agreement on group accidental death, dismemberment and permanent total disability.

As of December 31, 1968 the Company also had in effect agreements with three authorized companies providing for cession on a facultative basis.

All of the above reinsurance contracts include the customary insolvency clause.

Assumed

In a reinsurance agreement effective October 1, 1968 between the Company and its subsidiary, ITT Life Insurance Company of New York, the Company agrees to indemnify ITT Life of New York at the end of the contract year that portion by which the covered losses (amount of death claims less the reserves thereon) incurred by ITT Life of New York on the covered amount at risk (the average of the life insurance in force less the average of the mean life insurance reserves thereon) exceed 100 per cent of expected mortality according to the 1955–60 Select Basic Mortality Table. ITT Life of New York agrees to pay the Company at the end of the contract year a premium of $100 plus the excess, if any, of the expected covered life insurance mortality over the actual mortality of the covered lives. The maximum covered amount at risk on any one life under the agreement is $57,500.

In an agreement with Equitable Life Assurance Society of the United States, the Company agrees to reinsure a certain portion of the premiums and liabilities under certain group life and accident and health policies issued by Equitable to the International Telephone and Telegraph Corporation.

As of December 31, 1968, the Company had in effect reinsurance agreements with the following companies under which the Company agrees to reinsure 100 per cent of the credit life and credit accident and health insurance written upon the lives of debtors of the subsidiaries of ITT Aetna Corporation located in the following states:

Pilot Life Insurance Company, Maryland and Alabama
Old Republic Life Insurance Company, Pennsylvania
National Fidelity Life Insurance Company, Arizona

SPECIAL AND DEPARTMENTAL DEPOSITS

The deposits of securities as shown in the following schedule were confirmed by certificates and/or certified listings received direct from the respective depositories:

Depository	Accepted deposit value	Amortized value	Market value
Bonds:			
Missouri	$4,028,715	$4,289,921	$3,778,500
Colorado	350,000	349,793	343,000
Delaware	100,000	100,278	92,000
Guam	150,000	122,218	120,000
Total bonds	$4,628,715	$4,862,210	$4,333,500
Stocks: Georgia	$30,000	$0	$30,000

Of the total deposited with the Missouri Insurance Division, bonds with a par value of $300,000 and a market value of $282,000, represent the capital deposit requirement while the remaining deposit is in connection with the policy registration laws of Missouri. The amount of deposit required for net policy reserves on outstanding registered business at December 31, 1968, is $2,171,711.93.

At the time the Company acquired the business of the Alexander Hamilton Life Insurance Company, a Delaware corporation, with administrative offices in Denver, Colorado, the latter had on deposit United States Treasury bonds of an aggregate par value of $350,000.00 with the State Insurance Department of Colorado, and this deposit has been undisturbed ever since.

The remaining deposits with the various jurisdictions are for qualifying purposes.

FINANCIAL STATEMENT

Following is a financial statement of the Company's condition at the close of business December 31, 1968, as determined by this examination, subject to explanatory comments regarding the various items. This statement consists of assets, liabilities, surplus and other funds, together with several re-

lated exhibits, encompassing operations for the one year period ended December 31, 1968.

Assets:	
Bonds	$14,521,847.74
Stocks:	
Preferred	754,108.50
Common	1,534,305.03
Mortgage loans on real estate	220,302.68
Policy loans	4,445.33
Cash and bank deposits	641,184.67
Amounts recoverable from reinsurers	27,000.00
Premiums receivable	989,153.94
Due under co-insurance agreements	30,004.60
Life insurance premiums and annuity considerations deferred and uncollected	630,119.58
Accident and health premiums due and unpaid	702.20
Investment income due and accrued	203,888.22
Funds held by or deposited with ceding reinsurers	47,211.00
Total	$19,604,363.58
Liabilities, surplus and other funds:	
Aggregate reserve for life policies and contracts	$7,788,306.83
Aggregate reserve for accident and health policies	3,103,742.69
Policy and contract claims:	
Life	428,772.57
Accident and Health	352,657.65
Premiums and annuity considerations received in advance	9,193.71
Liability for premium deposit funds	7,911.05
Commissions to agents due or accrued	333,733.41
General expenses due or accrued	83,166.40
Taxes, licenses and fees due or accrued	225,454.73
Federal income taxes due or accrued	1,189,806.63
"Cost of collection" on premiums etc., in excess of loading thereon	107,860.06
Amounts withheld or retained by company as agent or trustee	15,747.88
Remittances and items not allocated	26,045.80
Mandatory securities valuation reserve	38,048.65
Deferred pension benefits	3,500.00
Due to subsidiary	211,287.14
Total Liabilities	$13,925,235.20
Mortality fluctuation reserve	537,200.00
Capital paid-up	1,000,000.00
Gross paid in and contributed surplus	2,580,348.74
Unassigned surplus	1,561,579.64
Total	$19,604,363.58

SUMMARY OF OPERATIONS

(Accrual Basis)

Premiums and annuity considerations—Life	$7,077,995.92
Premiums and annuity considerations—Accident and Health	7,964,206.49
Considerations for supplementary contracts without life contingencies and dividend accumulations	0
Net investment income	1,247,735.57
Other income	384.66
Total	$16,290,322.64
Deduct:	
Death benefits	$2,436,601.84
Annuity benefits	564,979.80
Disability benefits	1,315.54
Surrender benefits	8,627.04
Group conversions	(780.00)
Benefits under accident and health policies	3,739,281.28
Interest on policy or contract funds	223.59
Increase in aggregate reserve for policies and contracts with life contingencies	411,277.86
Increase in reserves for accident and health policies	1,906,316.88
Sub-Total	$9,067,843.83
Commissions on premiums and annuity considerations	1,702,748.51
General insurance expenses	1,391,387.36
Insurance taxes, licenses and fees	298,421.66
Increase in loading on and cost of collection in excess of loading on deferred and uncollected premiums	174,030.71
Total	$12,634,432.07
Net gain from operations before dividends to policyholders and federal income taxes and excluding capital gains and losses	$3,655,890.57
Dividends to life policyholders	$912,657.00
Dividends on accident and health policies	577,054.00
Total	$1,489,711.00
Net gain from operations after dividends to policyholder and federal income taxes and excluding capital gains and losses	$2,166,179.57

SURPLUS ACCOUNT

Gross paid in and contributed surplus, 12-31-67.	$2,580,348.74	Federal income tax due or accrued.	$1,189,806.63
Unassigned surplus, 12-31-67	2,008,102.58	Due to subsidiary	211,287.14
Adjustment on prior yrs., depreciation.	10,274.71	Net capital losses	700,543.01
Funds held or deposited with ceding reinsurers.	47,211.00	Net loss from non-admitted & related items.	48,597.56
Over accrual of income tax	29,942.57	Increase in mandatory securities valuation res.	12,800.43
Net gain	2,166,179.57	Special Surplus funds 12-31-68	537,200.00
Overpayment of income tax	103.98	Gross paid in & contributed surplus 12-31-68.	2,580,348.74
		Unassigned surplus December 31, 1968.	1,561,579.64
Total	$6,842,163.15	Total	$6,842,163.15

RECONCILIATION OF LEADER ASSETS

Increase in Ledger Assets:		
Premiums on life policies and annuity considerations		$6,693,876.77
Accident and health cash premiums		8,021,745.62
Gross investment income		1,217,383.82
Miscellaneous income		488.64
Contribution for employees retirement benefits		3,500.00
Prior years depreciation adjustment		10,274.71
Increase in ledger liabilities during year		68,001.34
From sale or maturity of ledger assets		101,105.85
Total Increase in Ledger Assets		$16,116,376.75
Decrease in Ledger Assets:		
Policy and contract claims—Life	$2,754,735.61	
Policy and contract claims—A&H	3,779,883.62	
Surrender value	8,627.04	
Group conversions	(780.00)	
Interest on policy loans	223.59	
Dividends to policyholders:		
Life and annuities	912,657.00	
Accident and health	557,054.00	$8,032,400.86
Commissions to agents:		
Life and insurance and annuities	$927,937.15	
Accident and health	684,304.91	1,612,242.60
General expenses		1,391,992.72
Taxes, licenses and fees		148,689.93
From sale or maturity of ledger assets		142.64
Total Decreases in Ledger Assets		$11,185,468.21

Reconciliation Between Years:	
Amounts of Ledger Assets December 31, 1967	$17,217,213.57
Increase in Ledger Assets During the Year	4,930,908.54
Total—Ledger Assets December 31, 1968	$22,148,122.11

EXHIBIT 13—ASSETS

	Ledger Assets	Non-Ledger Assets	Assets Not Admitted	Net Admitted Assets
Bonds	$14,521,847.74			$14,521,847.74
Stocks:				
Preferred stocks	754,108.50			754,108.50
Common stocks	5,894,497.32		$4,360,192.29	1,534,305.03
Mortgage loans: First liens	223,177.68		2,875.00	220,302.68
Policy loans	4,445.33			4,445.33
Deposits in banks and trust companies	641,184.67			641,184.67
Premiums receivable		$989,153.94		989,153.94
Amounts recoverable from reinsurers		27,000.00		27,000.00
Agents' balances (debit $4,941.56 credit $0)	4,941.56		4,941.56	
Furniture and equipment	73,824.62		73,824.62	
Due under co-insurance agreement	30,094.69			30,094.69
Life insurance premiums deferred and uncollected (less reinsurance premiums):				
Ordinary deferred and uncollected				
New business (excluding $138,010.31 loading) $133,244.58				
Renewal (excluding $156,181.62 loading) $496,522.24		630,119.58		630,119.58
Group life deferred and uncollected (excluding $910.03 loading) $352.76				
Accident and health premiums due and unpaid		702.20		702.20
Investment income due and accured		203,888.22		203,888.22
Funds held by or deposited with ceding reinsurers		47,211.00		47,211.00
Totals	$22,148,122.11	$1,896,074.94	$4,441,833.47	$19,604,363.58

COMMENTS ON FINANCIAL STATEMENT

Assets

Bonds, $14,521,847.74

Bonds owned by the Company at December 31, 1968, are classified and valued in the following schedule:

Classification	Amortized and Book Value	Par Value	Actual Cost	Market Value
Government: United States	$1,816,969.22	$1,830,000.00	$1,811,357.14	$1,782,863.38
States, Territories and Possessions:				
United States	40,425.48	40,000.00	40,456.80	40,425.48
Canada	590,852.54	598,000.00	588,907.50	590,852.54
Political Subdivision of States, Territories and Possessions: United States	404,573.33	400,000.00	404,043.50	404,573.33
Special Revenue: United States	94,748.12	100,000.00	94,000.00	79,000.00
Railroads: United States	571,956.03	633,248.00	568,736.11	546,179.46
Public Utilities: United States	7,194,548.64	7,277,000.00	7,185,602.73	6,615,117.79
Industrial and Miscellaneous: United States	3,807,774.38	3,846,145.18	3,803,688.17	3,609,793.87
Totals	$14,521,847.74	$14,724,393.18	$14,406,741.95	$13,668,805.85

Bonds are entered on the Company's books at actual cost, and the book values are adjusted each year to record amortization of premium and accrual of discount, computed on basis of effective rate of yield. All bonds were found to be eligible for amortization and none were in default as to principal or interest. A complete check of the Company's computations of accruals of discounts and amortization of premiums on the scientific method for the period under review indicated correctness and subsequent proper entries being made, and the amortized value of bonds owned December 31, 1968 as reported by the Company was accepted without change.

Market values reflected in the foregoing exhibit were calculated in accordance with the resolutions adopted by the Committee on Valuations of Securities of the National Association of Insurance Commissioners. Prices quoted in the manual published by the Committee were used to value all issues for which market prices were available. Private placements, municipals and other unlisted issues were valued at the Company's amortized values at December 31, 1968.

Bonds owned by the Company at December 31, 1968 were accounted for at par value as follows:

	Par Value
Vault: First National Bank In St. Louis, Saint Louis, Missouri	$5,470,000.00
Vault: First National City Bank, New York, New York	3,354,393.18
Deposit: Colorado Insurance Department	350,000.00
Deposit: Delaware Insurance Department	100,000.00
Deposit: Guam Insurance Department	150,000.00
Deposit: Missouri Insurance Department	4,300,000.00

	Par value
Check of accounting records for Treasury Bills that matured in 1969 prior to date of physical inspection	1,000,000.00
Par value of bonds owned December 31, 1968	$14,724,398.18

Bonds in the vault of the First National Bank in St. Louis, Saint Louis, Missouri, were verified by physical inspection and count on April 2, 1969, by the Examiners.

Bonds in the vault of the First National City Bank, New York, New York, were held under a custodial agreement for safe keeping. The custodial agreement was reviewed and found to be in order. The bonds in the custodian's possession were verified by certificate received directly from the custodian.

Bonds on deposit with the Colorado, Delaware, Guam and Missouri Insurance Departments were verified by certificates received directly from the respective custodians.

The activity in the bond account during the period under review was as follows:

Book value at beginning of year		$4,687,581.71
Acquisitions:		
Cost of bonds acquired	$49,308,997.55	
Increase by adjustment [1]	68,105.43	
Profit on sales	5,057.82	
Due to merger Alexander Hamilton Life Insurance Company	528,499.43	49,910,660.23
		$54,598,241.94
Disposals:		
Considerations on sales	$40,041,782.04	
Decrease by adjustments [1]	4,145.14	
Loss on sales	30,467.02	40,076,394.20
Book value December 31, 1968		$14,521,847.74

[1] Amortization of premium and/or accrual of discount.

Acquisitions and disposals of bonds during the period under review were confirmed by a review of vouchers, invoices, bank correspondence, receipts and other data. All investments were approved at the meeting of the Board of Directors.

Bond interest received in the amount of $541,893.55 net of $13,321.13 accrual of discount, $1,943.41 amortization of premiums and $30,508.25, paid for accrued interest on purchases during 1968 was checked in detail. Accrued interest as of

December 31, 1968, as computed by the Company was verified in detail during the course of this examination, and was found to be correct as reported. The amount of $203,618.11, as reported in the Company's Annual Statement, has been included in the financial statement of this report as a non-ledger asset.

Without consideration of reinvestment of interest income or of investment expenses, the following statement reflects bond interest earned as a percentage of the mean book value of bonds for the years covered by this examination:

	1965	1966	1967	1968
Mean book value	$8,141,177.58	$11,910,833.50	$10,505,923.03	$11,653,399.62
Interest earned	$174,297.71	$386,057.60	$534,875.95	$685,330.97
Yield percentage	2.141%	3.241%	5.091%	5.881%

Stocks, $2,288,413.53

The Company's investment in stocks as of December 31, 1968, consisted of 11,250 shares of preferred stock with a cost, book and admitted value of $754,108.50, and 484,464 ¼ shares of common stock with a cost and book value of $5,894,497.32 and a market and admitted value of $1,534,305.03 summarized by classification as follows:

Classification	Number Shares	Cost and Book Value	Admitted Value
Preferred: Public Utilities	11,250	$754,108.50	$754,108.50
Total preferred	11,250	$754,108.50	$754,108.50
Common:			
Public Utilities	2,300	$108,129.69	$91,800.00
Banks, trust and insurance companies	445,591	5,397,005.79	1,077,657.03
Savings and Loan deposits		30,000.00	30,000.00
Industrial and miscellaneous	36,573¼	359,361.84	334,848.00
Total common	484,464¼	$5,894,497.32	$1,534,305.03
Total preferred and common	495,714¼	$6,648,605.82	$2,288,413.53

The foregoing admitted values were established in accordance with appropriate resolutions adopted by the National Association of Insurance Commissioners, such resolutions providing for the methods by which securities shall be valued by insurance companies in preparing Annual Statements.

The Company has elected to value its preferred stocks at cost for statement purposes.

The admitted value for common stocks owned at December 31, 1968, was established from association market values listed in the N.A.I.C. Publication, "Valuation of Securities" as of December 31, 1968, or values determined by methods prescribed in that publication.

The excess of book value over market value of common stocks, in the amount of $4,360,192.29 has been included in the Financial Statement of this report as a not-admitted asset.

In addition to the above captioned amount, the Company owned common stocks of various subsidiary Aetna Finance Companies in its portfolio as of the examination date. These stocks were contributed to the Company by the ITT Aetna Finance Company, assigned an arbitrary value of $1.00 per share for a total book value of $31,865.25 but also shown as an asset not admitted in the same amount thereby refraining from taking any credit as an admitted asset in the Annual Statement. This identical treatment has been followed for this report as these stocks are not listed in the N.A.I.C. Valuations of Securities as of December 31, 1968.

The Company owned 98.7% of the common stock of ITT Life Insurance Company of New York, a New York Corporation. The Company followed the method prescribed by N.A.I.C. publication "Valuations of Securities" in determining the admitted value of this stock as of December 31, 1968.

The Company had on deposit with the Insurance Department of Georgia, $30,000.00 which consisted of three $10,000.00 Savings and Loan Association Investment Ceritficates. This deposit was verified by certification received directly from the custodian.

Stocks in the vault of the First National Bank in St. Louis, Saint Louis, Missouri, were verified by physical inspection and count on April 2, 1969, by the Examiners. All certificates were found to be registered in the Company's name.

Stocks in the vault of the First National City Bank, New York, New York, were held under a custodial agreement for safekeeping. The custodial agreement was reviewed and found to be in order. The stocks in the custodians possession were verified by certificate received directly from the custodian.

The Aetna Finance Company stocks were physically inspected and counted on April 23, 1969, by the Examiners in the Company's office. These stocks are in the name of the Company and during the course of this examination were placed in a safe deposit box in the Saint Louis County National Bank, Clayton, Missouri, for safekeeping.

The following exhibit reflects the activity in the Company's stock account during the period under review.

Book value at beginning of year		$162,079.25
Acquisitions:		
Cost of stocks acquired	$9,036,993.03	
Profit on sales	116,307.20	
Due to merger Alexander Hamilton Life Insurance Company	232,963.55	9,386,263.78
		$9,548,343.03
Disposals:		
Considerations of sales	$619,363.47	
Loss on sales	25.00	
Due to merger Alexander Hamilton Life Insurance Company	2,280,348.74	2,899,737.21
Book Value December 31, 1968		$6,648,605.82

Acquisitions and disposals of stocks during the period under review were confirmed by a review of vouchers, invoices, bank correspondence, receipts and other data. All investments were approved at the meetings of the Board of Directors.

The Company's investment in mortgage loans on real estate at December 31, 1968, amounted to $220,302.68, and are classified as follows:

Class	Number	Unpaid Balance
V.A. Loans	1	$16,659.21
Conventional	4	203,643.47
Totals	5	$220,302.68

The following schedule shows the number and amount of loans owned, distributed by jurisdiction:

Jurisdiction	Number of Loans	Unpaid Balance
Colorado	2	$39,476.27
Missouri	2	161,298.55
Washington	1	19,527.86
Totals	5	$220,302.68

The following schedule shows the number of loans at their specific rates of interest and the unpaid balance as at December 31, 1968:

Number of Loans	Interest Rate	Unpaid Balance
1	5¼%	$16,659.21
2	5½%	42,344.92
1	6%	139,500.00
1	6½%	21,798.55
5	Totals	$220,302.68

These loans are classified as follows:

Type	Number of Loans	Unpaid Balance
Residence	4	$80,802.68
Commercial	1	139,500.00
Totals	5	$220,302.68

Mortgage Loans on Real Estate

The principal balances outstanding as of December 31, 1968, was compiled from the Company's subsidiary investment records.

Transactions in mortgage loans on real estate during the period under review were as follows:

Book value of mortgages owned December 31st, of previous year		$0
Cost of Mortgages Purchased	$202, 500. 00	
Due to merger Alexander Hamilton Life Insurance Company	64, 133. 64	266, 633. 64
Less: Payments on principal		(43, 455. 96)
Book value of mortgages owned end of year		$223, 177. 68

Interest received in the amount of $13,178.47 was verified and found to be correct as reported by the Company in its 1968 Annual Statement.

Accrued interest in the amount of $194.08 was not reported by the Company in its 1968 Annual Statement. This amount has been included in the admitted assets of this report under the caption "Investment Income Due and Accrued."

Escrow funds in the amount of $1,727.19 held by the Company on two mortgages are used to make disbursements for taxes and insurance as the occasion arises, and is included in the Company's 1968 Annual Statement among the liabilities under the caption "Amounts Withheld or Retained by Company as Agent or Trustee."

The resultant earnings on the mortgage loan account are indicated in the following exhibit:

	1965	1966	1967	1968
Mean Book Value	0	[1] $45, 000. 00	$197, 938. 53	$221, 777. 31
Interest Earned	0	$2, 677. 50	$13, 373. 40	$13, 178. 47
Rate of Return	0	5. 948%	6. 756%	5. 943%

[1] The only loan made in 1966 was made September 30, 1966 in the amount of $180,000.00. Since interest was earned on this loan for only three months, the mean book value has been shown as $45,000.00 to show a more meaningful rate of return for the year.

Loans made during the period under review were authorized at the meetings of the Board of Directors.

All pertinent documents covering loans were examined in detail as to mortgage, notes, deeds of trust, title policies, appraisals and hazard insurance policies. It was also determined that the Veteran Administration Loan was supported by proper Guarantee Certificate.

Company records showed that all tax payments were current.

Policy Loans, $4,445.33

This asset consists of twenty-two loans and represents the unpaid principal balance as of December 31, 1968. The loans bear interest at the rate of six percent per annum which is added to the loan or paid by the policyholder, at his option, on the next succeeding anniversary date of the policy. Interest is not computed or paid in advance. All loans were checked to the policy files and none were in excess of the cash values of the policies.

Interest due and accrued at December 31, 1968, in the amount of $76.03, has been shown as a non-ledger asset in the financial statement of this report.

Cash and Bank Deposits, $641,184.67

As of December 31, 1968, the Company maintained deposits in eleven banks and trust companies not on interest, aggregating the above amount.

Certifications of bank balances were obtained directly from the respective depositories and balances shown thereon reconciled with the Company's records. The depositories certified that the Company's accounts were free of liens, claims or encumbrances.

Interest received in the amount of $33,064.28 as reported by the Company at December 31, 1968, was found to be correct.

Amounts Recoverable from Reinsurers, $27,000.00

This non-ledger asset represents the amount due from a reinsurer on a loss paid by the Company prior to December 31, 1968. Vertification of this item was established from the settlement made by the reinsurer in January of 1969.

Premiums Receivable, $989,153.94

This non-ledger asset consists of premiums due from finance companies, banks and reinsurance assumed on individual and group credit life and credit accident and health business.

Premiums receivable at year end consisted of the following:

Life:		
Single premiums	$48,804.24	
Reinsurance assumed	42,466.37	$91,270.61
Group, direct	$272,077.91	
Group, pools	110,146.64	
Reinsurance assumed	5,834.25	388,058.80
Total life premiums		$479,329.41

Accident and Health:	*Individual*	*Group*	
Direct	$45,966.56	$384,821.12	
Pools		14,290.16	
Reinsurance assumed	29,328.62	35,418.07	
Totals	$75,295.18	$434,529.35	
Total accident and health			$509,824.53
Total premiums receivable			$989,153.94

The above amounts were verified by reports, settlements and deposits made subsequent to the year end. Commissions payable on the above premiums have been included in the liability section of this report under the caption "Commissions Due and Accrued".

The premiums receivable in the above schedule are shown by the Company separately from the deferred and uncollected premium schedule because in nearly all cases the premiums have been paid by the policyholder to the finance companies, banks, etc., but are not remitted to the Company until the following month.

Due Under Co-Insurance Agreements, $30,094.69

The above item represents premiums less commissions due for the months of October, November and December, 1968, under a co-insurance agreement. This was verified by the settlement statement and payment received by the Company in March of 1969.

Life Insurance Premiums Deferred and Uncollected, $630,119.58

		Ordinary		Group
	Total	1st Year	Renewal	Life
Gross Uncollected	$80,632.76	$6,420.22	$72,949.75	$1,262.79
Gross Deferred	844,588.78	264,834.67	579,754.11	----------
Total Gross	$925,221.54	$271,254.89	$652,703.86	$1,262.79
Less Loading	295,101.96	138,010.31	156,181.62	910.03
Net Deferred and Uncollected	$630,119.58	$133,244.58	$496,522.24	$352.76

All Ordinary business of the Company is administered in Denver, Colorado. This is now written directly by the Company, however, some insurance in force which was written in prior years in Puritan Life Insurance Company and The Credit Life Insurance Company was coinsured 50% in the Company.

Amounts of deferred and uncollected Ordinary business are determined by listing all policies in force grouped by originating company, premium mode, year and month of issue and year and month to which premiums are paid. The annual net life premium and the annual gross premiums for life, ADB, WP and substandard extra are listed. Amounts of deferred, uncollected and advance premiums are calculated by computer.

This list was test checked for method of determining these items, for accuracy of the net premium factors used and for accuracy of the insurance in force included.

A few policies were included on which premiums were overdue more than two or three months, however, these were also included in the reserve listings so the net liability is only slightly incorrect. On one plan, an incorrect net premium was used which resulted in a slight understatement of net deferred and uncollected premiums. This is being corrected for future listings. No change was made in this examination for these errors, since the net difference would be quite minor.

In addition to the regular life net premium, credit is taken for one-half of the gross premium on ADB and WP and for all of the gross substandard extra premium.

There is a small amount of group life premium due in connection with group business, other than group, administered in the St. Louis office.

Accident and Health Premiums Due and Unpaid, $702.20

This item is on individual A & H policies which are administered in Denver, Colorado. All policies with premiums due and unpaid are listed and the premiums on them are totaled. One or two monthly policies with premiums overdue more than one month were included for the full amount overdue, rather than only for one monthly premium on each. The overstatement of this asset was very minor so the Company's figure was accepted.

Investment Income Due and Accrued, $203,888.22

This non-ledger asset is comprised of the following:

Interest accrued on bonds	$203,618.11
Interest accrued on mortgage loans	194.08
Interest accrued on premium notes, policy loans and liens	76.03
Total	$203,888.22

The above captioned amount is $194.08 more than that reported by the Company in its 1968 Annual Statement. The increase of $194.08 was due to the Company not reporting interest accrued on mortgage loans.

Comments with respect to the foregoing items will be found under their related assets.

Funds Held By or Deposited With Ceding Reinsurers, $47,211.00

The captioned amount represents funds held by Old Republic Life Insurance Company, Chicago, Illinois to guarantee payment of incurred claims under a credit life and credit accident reinsurance agreement. Of the total amount of $47,211.00, $2,742.00 is apportioned to credit life and $42,773.00 to credit accident and health.

LIABILITIES

Aggregate Reserve for Life Policies and Contracts, $7,788,306.83

This item includes the reserve for regular Ordinary policies administered in Denver, Colorado and for individual credit life, group, credit life, other group and a group annuity administered in the St. Louis office. A breakdown of reserves in each office is as follows:

St. Louis Office	$6,139,757.83
Denver Office	1,648,549.00
Total	$7,788,306.83

A summary of reserves in the St. Louis office is shown below:

	Total	Ordinary	Group
Life Insurance:			
1941 CSO 3%, NL—			
Credit Life	$326,860.4	$33,611.85	$293,248.58
1960 CSG 3½%, NL—			
Credit Life	825,989.44	263,148.00	562,841.44

	Total	Ordinary	Group
Life Insurance—Continued			
1958 CSO 3% NL—Regular Group	$4,954.00	0	$4,954.00
Total Life Insurance	$1,157,803.87	$296,759.85	$861,044.02
Annuities: 1951 GA 3¼%, NL	$4,971,351.66	0	$4,971,351.66
Total Annuities	$4,971,351.66	0	$4,971,351.66
Miscellaneous: North Carolina Special Reserve	$10,602.30	$10,602.30	0
Total Miscellaneous	$10,602.30	$10,602.30	0
Grand Total—St. Louis Office	$6,139,757.83	$307,362.15	$5,832,395.68

The Company issues single premium level and single premium decreasing credit life insurance. In addition to direct issues, some credit life insurance is written by Pilot Life Insurance Company, Old Republic Life Insurance Company, and National Fidelity Life Insurance Company and ceded on a single premium basis to the Company. This insurance is written on an individual policy basis in some states and on a group basis in other states, however, all is of the single premium (rather than the outstanding balance) type.

Business written in Colorado, Florida, Ohio and Texas is valued on the 1941 CSO 3% basis; that written in other states is valued on the 1960 CSG 3½% basis.

The Company actually provides insurance for the greater of (1) the amount of insurance provided by the policy or certificate or (2) the amount of the loan balance. The latter is larger when loan payments are in arrears. The reserve is calculated on such higher amount.

Credit insurance policies or certificates are grouped by state, city or loan office, 10 year age group and 3 month durational group. They are listed individually, which leaves a good audit trail. Reserve factors are used which take account of the unexpired amount of insurance and the one year term reserve based on a mortality table and interest rate for an age which is believed to be representative of the age group as follows:

Ages	Under	20		Factor	Based	on	Age 18
"	"	20–29		"	"	"	" 26
"	"	30–39		"	"	"	" 36
"	"	40–49		"	"	"	" 45
"	"	50–59		"	"	"	" 55
"	"	60–65		"	"	"	" 63

The mortality factors and formulas for reserve calculation were checked. Those used for decreasing term were found to be correct, however, those for level term overstate the reserve by one-half month's insurance. The overstatement probably amounts to several thousand dollars, however, it could not be readily calculated exactly. This correction has not been made in the totals above. The overstatement of reserve has been brought to the attention of the Company and will be corrected in future valuations.

There is a small reserve on regular group life insurance.

The annuity reserve is on retired lives under a pension plan of the parent or an affiliated company. Reserves are calculated using a rather exact formula which recognizes a partial final payment at death.

North Carolina, by regulation requires with respect to credit life and credit A & H that "at least 40% of the gross premiums written by each agent must be accumulated by the insurance company indefinitely as an irrevocable reserve". This has been interpreted to mean that the total reserve on North Carolina direct business must be 40% of written premiums less 100% of claims, both on a to-date basis. The regular life and A & H reserves are included in their respective categories. The amount shown for this item represents the excess of the North Carolina requirement over the regular reserve. In calculating this reserve, the Company failed to deduct the A & H reserve held elsewhere, which amounted to $47,904.06. In correcting this, $31,438.96 of this reserve classified as A & H has been eliminated and the life portion has been reduced by $16,465.10, i.e. from the Company's figure of $27,067.40 to the $10,602.30 shown above.

A summary of the reserves on business in the Denver office, all of which is on Ordinary business, is shown below.

Life Insurance:

1958 CSO 3%, CRVM, Age Last Birthday	$1,511,660.00
" " " NL " " "	13,615.00

Life Insurance—Continued

Substandard Extra	$29,209.00
Total Gross	$1,554,484.00
Reinsurance	9,622.00
Total Net	$1,544,862.00
Accidental Death Benefits:	
Total Gross	$73,023.00
Reinsurance	4,809.00
Total Net	$68,214.00
Disability—Active Lives:	
Total Gross	$23,632.00
Reinsurance	188.00
Total Net	$23,444.00
Disability—Disabled Lives: Total Net and Gross	$3,791.00
Miscellaneous: Non Deduction—Total Net and Gross	$8,238.00
Grand Total	$1,648,549.00

The Ordinary business is grouped in order of originating company, plan, year of issue and age at issue. Each policy is listed and the appropriate life reserve is calculated. An estimate of the reserve was included for a few policies for which there were no matching reserve factors. The Company uses a three year age setback for reserves on female lives on most plans. The age last birthday method is used. Curtate functions are used.

The reserve for substandard extra premiums is calculated as one-half of the gross extra premium on policies in force.

The reserve for reinsurance ceded is calculated as one-half of the annual reinsurance premium on policies in force.

The reserve for accidental death benefits and disability active lives is calculated as one-half of the gross annual premium in force, which is an estimate of the tabular reserve. Since this business is less than five years old, with an average duration of about two years, this is probably a conservative estimate. However the amounts of reserve are large enough that a more exact and direct estimating technique should be used. This has been recommended to the Company.

The Company does not deduct deferred fractional premiums at death, however, it does not refund previously due premiums paid beyond the date of death. The non-deduction reserve is calculated by a method which relates the reserve to the amount of deferred premiums. The method is somewhat conservative on limited pay life plans, but gives a very accurate reserve on other plans.

Premiums were inspected and it was determined that no deficiency reserve is required.

In recapitulating, the reserve shown by the Company was adjusted to the amount shown above as follows:

Reserve Shown by Company	$7,804,771.93
Correction of North Carolina Special Reserve	(16,465.10)
Corrected Reserve	$7,788,306.83

Aggregate Reserve for Accident and Health Policies, $3,103,742.69

This item includes the reserve on credit A & H and regular group A & H insurance administered in the St. Louis office and on a small amount of individual guaranteed renewable disability policies administered in the Denver office.

The amounts of reserve held on each of these categories of business is as follows:

Denver office	$7,991.65
St. Louis office	3,095,751.04
Total	$3,103,742.69

The reserve on the individual disability policies is as follows:

Active Life Reserve:	
Unearned Premiums—Total Gross	$3,455.82
Reinsurance Ceded	2,457.65
Total Net—Active Life Reserve	$998.17
Claim Reserve:	
Present Value of Amounts Not Yet Due—Total Gross	$9,517.88
Reinsurance Ceded	$2,524.40
Total Net—Claim Reserve	$6,993.48
Grand Total	$7,991.65

The unearned premium reserve is calculated using the exact fraction as if each premium due date were in the middle of the month.

No additional reserve calculated on a morbidity table and interest rate is held since almost all business was of less than two years duration. An additional reserve will be calculated in future years when some business will be in its third year.

The claim reserve is estimated by assuming that claims will be 50% of earned premiums and subtracting paid and pending claims to arrive at the amount of liability for unaccrued claims. It appears to be a rather conservative estimate.

The reserve on individual credit, group credit and regular group A & H policies, i.e. those administered by the St. Louis office is as follows:

	Total	Group	Other
Active Life Reserve: Unearned Premium—Total Gross & Net	$2, 432, 501. 04	$2, 153, 903. 14	$278, 597. 90
Claim Reserve:			
Present Value of Amounts Not Yet Due	$631, 000. 00	$561, 000. 00	$70, 000. 00
Reserve for Future Contingent Benefits	32, 250. 00	32, 250. 00	0
Total Gross and Net	$663, 250. 00	$593, 250. 00	$70, 000. 00
Grand Total	$3, 095, 751. 04	$2, 747, 513. 14	$348, 597. 90

The unearned premium reserve is on credit A & H insurance. Both the group and individual business is sold on a single premium basis. The unearned premium reserve on business in Louisiana and part of that on Maryland and Rhode Island business is calculated on the pro-rata method. The balance of the unearned premium reserve is calculated on the rule of 78's, i.e. the sum-of-the digits, method. The factors were checked and found to be correct on the latter, but found to overstate the reserve by one-half month on the pro-rata method. The total overstatement is relatively minor because most of the busi-

ness is not valued on the pro-rata method. This was not corrected in the figures above, however, it was brought to the attention of the Company and factors will be considered in the future.

The reserve for "Present Value of Amounts Not Yet Due" is $490,340.00 greater than that reported by the Company, and is fully commented upon under the caption "Policy and Contra t Claims—Accident and Health."

The reserve for future contingent benefits, i.e. deferred maternity, is estimated from such type of claim payments in 1968 and from the growth in volume. The estimate appears to be reasonable.

The Company had included $31,438.96 of special reserve for North Carolina direct credit A & H policies. As discussed under the heading "Aggregate Reserve for Life Policies and Contracts", this reserve was overstated and has been eliminated from the A & H reserve above and reduced in amount in the life reserve item.

Policy and Contract Claims—Life, $428,772.57

The above liability consists of the following:

	Ordinary	Group	Total
In course of settlement	$134,040.87	$101,587.56	$235,628.43
Incurred but not reported	88,140.36	105,003.78	193,144.14
Totals	$222,181.23	$206,591.34	$428,772.57

The liability for ordinary life claims was verified from a review of the claims register and payments made in 1969 for claims incurred prior to January 1, 1969, with an additional amount reserved for claims reported subsequent to the experience period.

The amount for group claims was determined from a listing of payments made during the first four months of 1969 on claims incurred in 1968 and from reports received from ceding insurers.

Minor differences were noted during the review of the above. However, the differences were compensating and a change in

the liability as reported by the Company in its annual statement was deemed unnecessary.

A review of claims files determined that the Company settles claims promptly and in accordance with the policy contracts.

Policy and Contract Claims—Accident and Health, $352,657.65

This liability is $306,572.35 less than that reported by the Company. Whereas the above captioned amount includes only that portion of the claims liability applicable to "accrued" claims at December 31, 1968, comments on the associated reserve for "unaccrued claims" are combined hereunder in lieu of separate remarks under the sub-heading "Present Value of Amounts Not Yet Due on Claims" in the "Aggregate Reserve for Accident and Health Policies" section of this report. Both liabilities are shown in the following schedule by classification:

	Per Company	Examination Change	Per Examination
Liability for Accrued Claims:			
Credit (Individual and Group)	$503,731.00	($376,900.68)	$126,830.32
Group	142,000.00	70,550.00	212,550.00
Individual	1,275.00	(221.67)	1,053.33
FEGLI	12,224.00	0	12,224.00
Total Accrued	$659,230.00	($306,572.35)	$352,657.65
Reserve for Unaccrued Claims:			
Credit (Individual and Group)	$140,660.00	$490,340.00	$631,000.00
Group	0	0	0
Individual	6,993.48	0	6,993.48
FEGLI	0	0	0
Total Unaccrued	$147,653.48	$490,340.00	$637,993.48
Total Claim Liability	$806,883.48	$183,767.65	$990,651.13

The total claim liability as shown above is distributed between unaccrued and accrued as follows:

	Per Company	Examination Change	Per Examination
Unaccrued: Present value of amounts not yet due	$147, 653. 48	$490, 340. 00	$637, 993. 48
Accured:			
In course of settlement	$56, 867. 15	$38, 638. 34	$95, 505. 49
Incurred but not reported	602, 362. 85	(345. 210. 69)	257, 152. 16
Total accrued	$659, 230. 00	($306, 572. 35)	$352, 657. 65
Total Claim Liability	$806, 883. 48	$183, 767. 65	$990, 651. 13

A total claim liability for accrued and unaccrued claims on credit A & H is estimated by an analysis of claims by month of accrual and month of payment. The reserve is being phased into the figures determined from this study. In addition, an estimate of the total claim liability is made for regular group and an amount is included for FEGLI. In years prior to 1968, the comparison in Schedule H (and in earlier years Schedule O) indicated the total A & H claim liability was inadequate.

In establishing the total examination reserve for credit and group claims, a four month development period was used and the ratio of paid claims was compared with the Company's past experience, both on a cumulative as well as on an incurred month basis. Appropriate lag factors were established to estimate the amount still unpaid based upon the lag indicated as compared with previous experience.

Premiums Received in Advance, $9,193.71

This liability is held with respect to the Ordinary policies administered in Denver, Colorado. The entire amount is on life insurance; any advance premiums on A & H insurance is included by the Company in the unearned premium reserve.

Advance premiums are determined in conjunction with deferred and uncollected premiums. All policies are grouped by company (i.e. direct business or that reinsured from Puritan Life Insurance Company or The Credit Life Insurance Com-

pany), month and year of issue and month and year to which premiums are paid. Each policy is listed individually. The computer calculates the amount of advance premiums. In this calculation, any premium paid in advance of its due date but not beyond the policy anniversary is offset against the amount of deferred premium.

Premium Deposit Funds, $7,911.05

The above ledger liability consists of amounts paid in advance which will be used to pay the premiums on the anniversary or due dates of the policies.

The Company maintains a listing of the policies involved showing the anniversary date, payment amounts and dates and the balance in the fund. The policyholders may make payments on a monthly, quarterly, semi-annual or annual basis. A review of the records disclosed no errors of consequence.

Commissions Due or Accrued, $333,733.41

This liability consists of commissions payable on the premiums receivable shown in the asset section of this report, to agents writing ordinary business and on a contract in which the commissions are settled or paid on an annual basis. It is divided between life and accident and health business as follows:

Life	$150,592.14
Accident and health	183,141.27
Total	$333,733.41

The above was determined by using actual payments and reports of commissions incurred.

General Expenses Due or Accrued, $83,166.40

This liability was established by a review of paid invoices and disbursement records pertaining to expenses paid subsequent to December 31, 1968, but having their origin on or prior thereto.

The captioned amount is $25,581.58 in excess of the liability reported by the Company in it's 1968 annual statement.

Taxes, Licenses and Fees Due or Accrued, $225,454.73

The captioned amount represents the Company's liability for taxes, licenses and fees due or accrued at December 31, 1969. The major portion of this amount consisted of state premium taxes, which were paid during the course of this examination. The remainder of the above amount was made up

of the usual items, such as state licenses and fees, F.I.C.A. taxes and miscellaneous taxes.

The captioned amount was determined by an examination of the Company's tax returns and related items for the year 1968, and resulted in a decrease of $29,430.20 less than that reported by the Company in it's 1968 annual statement. This difference was determined to be an advance partial payment of premium taxes to California and Ohio, for which the Company did not take credit in it's Annual Statement.

Federal Income Taxes Due and Accrued, $1,189,806.63

On August 18, 1967, the Company filed claims for refund of taxes paid for the years 1963, 1964 and 1965 totaling $343,884.04. No action having been taken by the Revenue Service to allow or disallow the claims, the Company on April 4, 1968, filed suit for refund in the United States Court of Claims. This suit is still pending.

On October 24, 1968, the Commissioner of Internal Revenue mailed the Company a statutory notice of deficiencies for the years 1963, 1964 and 1965, totaling $965,774.95 plus interest. Subsequently, notices of assessment and demand for payment dated February 25, 1969, were received by the Company. The Company paid the deficiencies and interest on March 5, 1969.

On April 21, 1969, the Company filed claims for refund of taxes and interest paid totaling $1,197,684.97. These claims and the suits in the United States Court of Claims are still pending as of the examination date of this report. The deficiencies in tax were based on industry-wide issues being contested in the courts by other companies.

The amount shown above includes the deficiencies paid plus the interest to December 31, 1968. The income tax return for the calendar year 1968 has not been filed as of this date, the Company having been granted an extension of time to file its return, and it appears that no tax is due.

Cost of Collection on Deferred and Uncollected, $107,860.06

Premiums in Excess of Total Loading

In 1968, the Company determined this liability for the first time. Prior to 1968, first year commission rates were relatively low. In 1968, two increases in the first year commission rate were granted, so that the rate with all overrides on life plans is 90%. Renewal commission rates were reduced, however, exist-

ing renewal business continues to be subject to the higher renewal rates.

This liability was determined as the excess of a 90% first year commission rate over the amount of first year loading in deferred and uncollected premiums. It is a rather conservative method of determining this item in that (1) not all plans take the 90% commission rate, (2) the first year business issued earlier in 1968 was subject to lower commission rates and (3) the loading margin in renewal years is not used as an offset to the loading deficiency in the first year.

Amounts Withheld or Retained by Company as Agent or Trustee, $15,747.88

The above captioned liability is composed of the following accounts:

Decor Interiors	$5,796.78
Employees' insurance withheld	421.67
Employees' savings bonds withheld	336.27
Missouri State Tax withheld	980.14
Federal income tax withheld	4,357.09
Federal income tax withheld—Puerto Rico	161.55
Federal Insurance Contributions Act Taxes withheld	809.50
Federal Insurance Contributions Act Taxes withheld—Puerto Rico	94.21
Accrued Colorado State withholding tax	1,016.22
Accrued California Unemployment Compensation and Disability Tax withheld	47.26
Mortgage escrow funds	1,727.19
Total	$15,747.88

Decor Interiors

This liability covers interior decorations made in the office in which the Company was not satisified and payment was held up until this was corrected. This was paid by the Company on January 24, 1969.

Employees' insurance withheld

This item is for additional insurance taken by the employees to supplement that for which the Company pays and also to cover the employees' dependents. This balance was verified by a review of the Company's records and found to agree with the amount reported in the Company's 1968 Annual Statement.

Employees' savings bonds withheld

The Company maintains savings bonds record cards to support this liability. Control cards were checked and found to agree with the amount as reported by the Company as of December 31, 1968.

The federal and state withholding taxes were verified by a review of tax reports and disbursements in January 1969, to ascertain dates of payment.

Mortgage escrow funds were verified and commented upon in connection with the examination of mortgage loans.

The subsidiary records of the above eleven liability accounts agreed with the Company's general ledger as of December 31, 1968.

Remittances and Items not Allocated, $26,045.80

Ledger suspense accounts and miscellaneous items are summarized as follows:

Cash with applications	$24,842.05
Old outstanding checks	1,043.26
Miscellaneous suspense	2,717.39
Due Hamilton Management Corporation	(2,556.90)
Total	$26,045.80

Old outstanding checks represent approximately 225 checks and were written in the years 1964 through 1967.

The debit balance in the "Due Hamilton Management Corporation" account represents the residual balance after accruals were reversed for annual statement reporting.

Mandatory Securities Valuation Reserve, $38,048.65

This item represents the accumulated reserve as of December 31, 1968, computed within the required limits, on the basis prescribed by the Valuations Committee of the National Association of Insurance Commissioners.

The accumulated reserve as of December 31, 1968, developed by this examination is $1,684.61 less than that reported by the Company in its 1968 Annual Statement.

The decrease was due to the Company's error in computing this reserve.

Deferred Pension Benefits, $3,500.00

The personnel of ITT Hamilton Life Insurance Company participate in the pension plan of the parent, International Telephone and Telegraph Corporation, with respect to service after August 31, 1964. In addition in 1968, four employees were granted a similar pension credit with respect to service with American Universal Life Insurance Company, the predecessor of ITT Hamilton Life Insurance Company, between September 1, 1959, and August 31, 1964. This was by Board resolution but it is not funded through the regular pension plan. The lump sum value of these benefits as of January 1, 1968, was calculated by ITT Hamilton Life Insurance Company's consulting actuaries as $25,846.00, however, the basis of this calculation was not the same as that used by the parent company in its pension calculations. ITT Hamilton Life Insurance Company proposes to set aside $3,500.00 each year for 15 years to provide for these benefits. This amount is not supported directly by a calculation, however it appears to be reasonable in the light of the calculated lump sum cost.

Due to Subsidiary, $211,287.14

This non-ledger liability represents tax benefits due the Company's subsidiary, ITT Life Insurance Company of New York. The Company issued its check and voucher on March 31, 1969, in payment of this liability.

Mortality Fluctuation Reserve, 0

The Company absorbs the mortality risk of ITT Life Insurance Company of New York through a reinsurance treaty under which it receives a premium equal to the expected cost of insurance plus a small expense charge. This became effective October 1, 1968. Experience in the first three months of this treaty was adverse to ITT Hamilton Life Insurance Company. Management set up a mortality fluctuation reserve in an amount roughly related to a year's projection of this adverse experience.

Although the Company classified this $537,200.00 as a liability, it has been reclassified by the examiners as a part of earmarked surplus. This is not for reserve strengthening nor for contingent losses having a measurable probability of occurrence. Thus it should be classified as earmarked surplus. The

setting up of any amount in this caption is entirely voluntary and within the discretion of management.

Capital Paid-Up, $1,000,000.00

Inspection of the Company's stock certificate books showed that there were two open stubs showing the issuance of 1,000,000 shares of stock having a par value of $1.00 each and is owned in its entirety by the ITT Aetna Finance Company.

All of the cancelled certificates including those of the former Alexander Hamilton Life Insurance Company, Denver, were accounted for during the course of this examination.

Surplus as Regards Policyholders, $4,679,128.38

After evaluating the assets and providing for all known liabilities and reserves the surplus of the Company as determined by this examination totaled $4,679,128.38. This amount is $738,407.09 less than shown in the Company's 1968 Annual Statement.

The items effected by the surplus changes are shown in the following reconciliation:

Total Surplus per Company, December 31, 1968 (Paid in $2,580,348.74; Unassigned $2,837,186.73)			$5,417,535.47
	Surplus Changes		
	Increase	Decrease	
Assets:			
Mortgage Loans		$2,875.00	
Investment Income Due and Accrued	$194.08		
Funds Held by or Deposited With Ceding Reinsurers	47,211.00		
Liabilities:			
Aggregate Reserve for Life Policy Contracts	16,465.10		
Aggregate Reserve for Accident and Health Policies		458,901.04	
Accident and Health Policy and Contract Claims	306,572.35		
General Expenses Due or Accrued		25,581.58	
Taxes Licenses and Fees Due or Accrued	29,430.02		
Federal Income Tax Due or Accrued		1,189,806.63	
Mandatory Security Valuation Reserve	1,684.61		
Mortality Fluctuation Reserve	537,200.00		
Total	$938,757.16	$1,677,164.25	
		(938,757.16)	
Net Decrease in Surplus			738,407.09
Total Surplus per Examination December 31, 1968			$4,679,128.38

(Special Surplus Funds $537,200.00; Paid in $2,580,348.74; Unassigned $1,561,579.64)

GENERAL COMMENTS

The following comments are offered in accordance with the recommendations contained on Pages A16 and A17 in the Examiners Handbook published by the National Association of Insurance Commissioners under the subject of "Procedure Regarding Examination Report."

Denver Office—This office produces all of the Company's Ordinary business and is closely associated with the Hamilton Funds, Incorporated, with offices also in Denver, Colorado. Many representatives of the latter also write insurance for the Company. The Denver office maintains accounting records, including a general ledger; collects premiums, pays its own operating expenses including claims. During the course of the examination two (2) examiners were dispatched to Denver, Colorado, to audit the affairs of this office.

A servicing agreement currently in effect with the Hamilton Management Corporation, generally provides that the servicing company will furnish the Denver office all necessary postage, office furniture and equipment, telephone charges and such other administrative, sales, sales promotional services and all other services for which no separate billing or agreement heretofore has been made.

In consideration for furnishing the foregoing the Company agrees to pay Hamilton Management Corporation a percentage of all First Year Premiums Collected by the Denver office, as follows:

Range		Percentage
First	$100, 000	15
Next	200, 000	10
Next	200, 000	5
Next	500, 000	3
Over	1, 000, 000	2

During the period under examination service fees have been paid, as follows:

1965	$42, 666. 28
1966	48, 233. 13
1967	47, 246. 25
1968	44, 628. 65

The aforedescribed service agreement may be terminated at any time upon sixty (60) days written notice by either party.

There is also in effect with the Hamilton Management Corporation a "Space Rental Agreement," whereby the Denver office subleases space at 777 Grant Street, Denver, Colorado, at $1,000.00 annually per each full time employee, payments to be calculated monthly. The rental agreement stipulates that space shall be limited to the amount that Hamilton Mangement Corporation, at its discretion, shall make available for use by the Company. Sums shown as rental disbursements in the Denver office general ledger during the period under review, were as follows:

1965	$16,915.00
1966	28,666.14
1967	34,581.95
1968	28,248.87

The Space Rental Agreement is in effect until May 31, 1974, and it along with the Service Agreement were negotiated by the Alexander Hamilton Life Insurance Company, before the Company acquired the business of the latter. However, all parties involved in the agreements are owned controlled by the International Telephone and Telegraph Corporation of New York.

Accounting Records—Two general ledgers are maintained by the Company, one for transactions of the Denver office and the other for Home Office business. At each year-end the accounts in these ledgers are combined and form the basis from which annual statements are prepared.

Also, at each year-end, the Company books all non-ledger assets and liabilities as respects Home Office transactions but such accruals are reversed in January of the following year. Under the circumstances it was necessary to adjust trial balances from the accrual to the cash basis in order to reconcile annual statement items.

The Company informs that commencing January 1, 1969, its general ledger accounts at year-end closing will reflect the conditions of such accounts on a cash basis.

CONCLUSION

The actuarial and related phases of this examination were performed by and under the supervision of Thurston P.

Farmer, Jr., F.S.A., Consulting Actuary of the Missouri Division of Insurance.

Following are the examiners of the Missouri Division of Insurance who were associated in the examination and the preparation of this report: Peter J. Gera and Edward A. McKee.

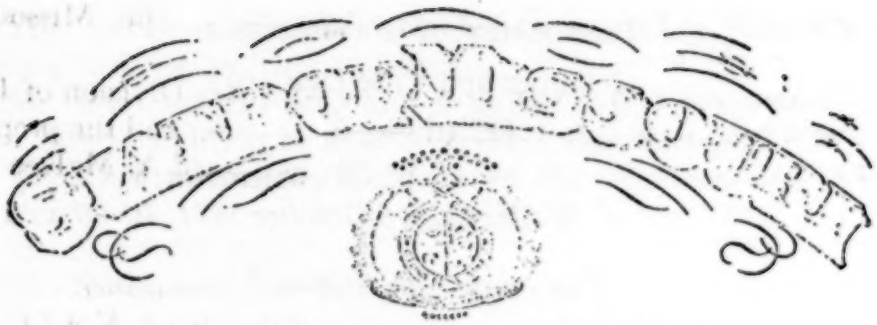
Respectfully submitted,

A. P. HOOD,
Examiner, Missouri Division of Insurance,
State of Missouri, Representing Zone 3, N.A.I.C.

EARL G. TERRY,
Examiner, Insurance Department,
State of Maryland, Representing Zone 2, N.A.I.C.

SVERRE MATHISON,
Examiner, Insurance Department,
State of Wyoming, Representing Zone 5, N.A.I.C.

HENRY CHIN,
Examiner, Department of Insurance,
State of California, Representing Zone 6, N.A.I.C.



DIVISION OF INSURANCE

DEPARTMENT OF BUSINESS AND ADMINISTRATION

CERTIFIED COPY

I, WILLIAM Y. McCASKILL, Superintendent of the Division of Insurance Department of Business and Administration of the State of Missouri, do hereby certify that the annexed pages are a true and correct copy of the original

Report of Examination of the

ITT HAMILTON LIFE INSURANCE COMPANY

as of December 31st, 1968

which said original is now on file in this Division.

IN TESTIMONY WHEREOF, I have hereunto set my hand and caused to be hereto affixed the seal of said Division, at my office in the City of Jefferson, this 8th day of August 19 69

WILLIAM Y McCASKILL
SUPERINTENDENT

By _____
DEPUTY SUPERINTENDENT

By Charles Salmon
CHIEF CLERK

BEST COPY AVAILABLE

TRANSCRIPT OF PROCEEDINGS

(Number and Title Omitted)

(Filed ——)

WASHINGTON, D.C.,
Wednesday, 6 October 1971, 10:00 a.m.

Testimony for Plaintiff

The parties met, pursuant to notice of the Commissioner, at the time above stated, in Trial Court Room 7, Court of Claims Building, Washington, D.C.

Present: Hon. Lloyd Fletcher, Commissioner; John B. Jones, Jr., Esq.; Andrew W. Singer, Esq.; and Owen Armstrong, Esq., counsel for Plaintiff; and Roger A. Schwarz, Esq., counsel for Defendant.

William L. Shimeta, a reporter, was thereupon sworn by the Commissioner to well and truly take down and transcribe the questions propounded to and the answers given by the witnesses, and to do all other things required of him by the Commissioner.

Pursuant to the order of reference by the Honorable, the United States Court of Claims, in the above-entitled cause, testmony on behalf of the Plaintiff was taken, as follows:

* * * * *

[18] MR. SINGER. Roger, have you decided whether to accept this witness as an expert?

MR. SCHWARZ. Yes, we will.

MR. SINGER. Can we then submit the first three paragraphs that I spoke to you about?

MR. SCHWARZ. Yes.

MR. SINGER. Mr. Fletcher, the parties have stipulated that Mr. Eddy has the following qualifications listed, [19] and we will give you a signed copy of that with our supplemental stipulation. Mr. Eddy.

THE COMMISSIONER. Good morning, Mr. Eddy. It is a pleasure to see you again.

ARTHUR CROOKS EDDY, a witness produced on behalf of the Plaintiff, having first been duly sworn by said Commissioner, was examined and testified as follows:

THE COMMISSIONER. Please be seated and state your full name and address for our reporter, please.

The WITNESS. My name is Arthur Crooks Eddy, 2935 Whispering Hills Drive, Atlanta, Georgia.

Mr. SCHWARZ. If I may, may I ask Mr. Eddy one question on voir dire in addition to what is listed in that paragraph?

The COMMISSIONER. Relating to the qualifications, Mr. Schwarz?

Mr. SCHWARZ. Yes.

The COMMISSIONER. Yes, you may.

By Mr. SCHWARZ:

Q. Mr. Eddy, in connection with your work as an actuary with Pilot and with other companies, and in your independent capacity as a consulting actuary, have you also prepared federal income tax returns for insurance companies?

[20] A. Frequently, yes.

Q. And you have considered the tax significance of many of the insurance concepts that are used in filling out the annual statement forms required and adapted those to proper use under federal income tax law?

A. I think that would be correct, yes.

The COMMISSIONER. Very well. I understand that Counsel are in agreement and will stipulate that the witness is qualified as an expert. Proceed, Mr. Singer.

Mr. SINGER: Thank you.

DIRECT EXAMINATION

By Mr. SINGER:

Q. Mr. Eddy, have you examined the accident and health reinsurance treaties between the American Universal Life Insurance Company, which, as you know, is the former name of ITT Hamilton, and the Old Republic, Pilot, and National Fidelity Life Insurance Companies?

A. Yes, sir, I have.

Q. For the record, those treaties are Exhibits #2, #4, and #6. Do these treaties, or any provisions of these treaties, appear unusual to you in any respect?

A. No, sir, not unusual. I think they are quite common in the credit insurance industry.

Q. Mr. Eddy, we have stipulated in this case that all [21] of the policies that were reinsured under these treaties were credit insurance policies on which a single premium was paid

to the insurance company at the inception of the policy coverage. Is there anything unusual in the fact that the reinsurance treaties here called for the payment of reinsurance premiums by the issuing company to ITT Hamilton on a monthly earned premium basis when the issuing company had received a single premium in advance, when it issued the policy?

A. No, I don't think so. In fact, I think that this is not an unusual arrangement in other types of reinsurance contracts. First of all, the contracts are between the two insurance companies and not between the ITT Hamilton and the policy holder, so it is a completely different arrangement. The policy holder may have individual life insurance. He may be paying his premiums on an annual basis, but the policy may be reinsured with another insurance company for the risk element, and the premium is to be remitted to the reinsurer, say, on a monthly basis. So I feel that that's not uncommon. In particular do you find this a common practice in the reinsurance of credit accident and health insurance.

Q. Thank you. Mr. Eddy, we have stipulated in this case that Old Republic, Pilot, and National Fidelity reflected unearned premium reserves on policies insured with ITT Hamilton in their annual statements. Perhaps before we [22] get to this, Mr. Eddy, perhaps you could clarify for the Court what is an annual statement—what is the purpose of an annual statement.

A. Well, the annual statement of a life insurance company, or life insurance company issuing life insurance and accident and health insurance, is a record of the income and disbursements of the company during the year on an accrual basis, as well as a balance sheet, representing their solvency, reflecting their solvency at the end of the accounting period, which is normally the calendar year. As a matter of fact, it is prescribed as the calendar year with respect to the life insurance companies.

Q. Must all life insurance companies file the same annual statement form?

A. Well, yes. The National Association of Insurance Commissioners have an organization, or is an organization which has over the, say, the last seventy years, at any rate, has been generally trying to create uniform regulation amongst the states, which includes the reporting or the accounting for the

life insurance industry, and all states to my knowledge have adopted this uniform convention blank which they have prescribed, including the instructions for the completion of this statement—well, as a matter of fact, for reporting to the supervisory or regulatory authorities. All insurance [23] companies in the United States use the same form.

Q. Now, getting back to my previous question, we have stipulated in this case that Old Republic and Pilot and National Fidelity all reflect on their annual statements their unearned premium reserves on the policies they issued and that they reinsured with ITT Hamilton, and conversely we also stipulated that ITT Hamilton did not reflect such unearned premium reserves on its annual statements.

Now, before we get into this matter any further, could you explain to us what the understanding is, as to what an unearned premium reserve is in the statutory sense or in the sense that it would be reflected on the annual statement.

A. Well, yes, an unearned premium reserve, as commonly thought of in the insurance business, is that portion of a premium which has been received which has not been earned at the valuation date.

By earned, I mean if the premium paid or received by the insurance company was to cover a period of time, say, as an example, one year, and the premium was received on July 1 and the valuation date would be December 31, then the unearned portion would be one-half of such premium, and that being, or representing, of course, the period of time of the coverage which had not yet been exposed to risk.

Q. Is it possible that an unearned premium reserve [24] might be required when a company, as of the statement date, had not received premiums, any portion of which you—or no portion of which was represented insurance to be provided in the future?

A. Not in my opinion, no, sir.

Mr. SCHWARZ. I didn't understand that question.

Mr. SINGER. Let me put it this way.

By Mr. SINGER:

Q. If a company received premiums which represented a payment for insurance, already provided by the company, and had received no other premiums by the time, at its statement

date, would it be required in your view to set up an unearned premium reserve?

A. You mean the period of coverage had expired with respect to the premium being paid?

Q. Yes, sir.

A. The valuation date?

Q. Yes.

A. There would be no unearned premium.

Mr. SINGER. Is that satisfactory?

Mr. SCHWARZ. Yes, thank you.

By Mr. SINGER:

Q. Mr. Eddy, could you tell us what function the unearned premium reserve serves—functions, if there are [25] more than one?

A. With respect to accident and health insurance?

Q. Yes.

A. Yes, the unearned premium, first of all, represents in part funds that must be held to provide the cost of the insurance risk which has not yet expired. The accident and health unearned reserves, which the industry requires, is statutory reserve—it is on a gross basis and, therefore, includes an additional amount over and above this cost of insurance risk which is frequently referred to as loading and represents a number of things.

It is rationalized in the industry, in accident and health insurance, as required in the event that the policy holder should cancel their coverages at that moment of time because the refund provisions in most such contracts and in credit contracts particularly, provide that they would be refunded their gross amount rather than the net amount for the unearned portion of their coverage, and, of course, this is an evolutionary thing, as far as the regulations, in my opinion, because the accident and health business in the early days in this country was strictly on a cancelable basis. It was short term coverages, and the policy holder and the company both had the opportunity or the right contractually to cancel the coverage at some midpoint of a period in which [26] event the policy holder generally was given a pro rata refund. And, of course, as most of this insurance in the early days was issued by casualty companies and in some cases specialty companies issuing just accident and sickness insurance, this requirement to reserve on a gross basis in

effect earmarked in a sense a portion of these companies' surpluses, which gave them an additional test of solvency as of a valuation date. Actually, if the coverage had expired, this redundancy would have been turned into income and gone into surplus. Have I answered your question?

Q. Well, as I understand your answer, you have given at least two reasons why a company is required under certain circumstances to set up an unearned premium reserve. One would be to measure the cost of carrying the insurance risk and the second would be to refund premiums to policy holders in the event of cancellation. Is that a fair summary of your testimony?

A. Right. I might add that since the probability of cancellation is less than one, that to hold all of the loading would be unnecessary for purposes of refunding. There might be an additional reason to hold a portion of the gross, and that would be for expenses not yet incurred, and companies might then have a reason—three reasons at least for gross unearned premiums as opposed to, say, net unearned premiums.

[27] Q. You mean to the extent that the expenses had not already been incurred, this loading portion might be viewed as a reserve for future expenses?

A. To that extent, yes, sir.

Q. But have I understood you to say that the gross unearned premium reserve is not a true measure of the cost of carrying the insurance risk or exceeds the cost of carrying the insurance risk?

A. That's correct. The insurance risk would be the morbidity element in accident and sickness insurance or the life insurance—I mean the death element—the mortality element in the life insurance policies.

Q. Then in your opinion, is the difference between the gross unearned premium reserve and this net premium element or morbidity reserve, is that a true insurance reserve?

A. Well, not in respect to the risk.

Q. From an actuarial standpoint?

A. Not in that respect.

Q. It is not necessary to cover the cost of carrying the insurance risk?

A. No, sir.

Q. Mr. Eddy, having read the treaties that I mentioned earlier, the accident and health treaties between ITT Hamil-

ton and Old Republic, Pi ot, and National Fidelity, do you have [28] an opinion as t whether, from an actuarial standpoint, from the standpoint of state regulatory practices, whether ITT Hamilton was proper in not reflecting unearned premium reserves under these treaties on its annual statements?

A. Yes, that is my opinion. I believe that to be——

Q. I asked you whether you had an opinion.

A. Yes, sir.

Q. What is that opinion?

A. My opinion is that they were proper in not including these reserves in their statement.

Q. Mr. Eddy, can you tell us what a runoff provision is?

A. Yes, that's a term that really—it's intended to reflect a provision, say on a reinsurance agreement, whereby the reinsurer is barred from canceling reinsurance with respect to policies in force at any moment of time, in protection of the ceding company or to protect the ceding company, and it causes the reinsurer, if he should want to cancel the contract, to guarantee to the ceding company that he will continue to accept premiums on such policies that were then in force and until they reached their normal expiration date and, of course, pay claims as a result of any losses.

Q. Do either the Old Republic or Pilot or National Fidelity accident and health reinsurance treaties that we [29] are speaking about here, contain a runoff provision?

A. Yes, two of them do. The Pilot and the National Fidelity treaties provide for that.

Q. The Pilot and National Fidelity treaties do provide a runoff provision?

A. Yes.

Q. Does the Old Republic treaty?

A. No.

Q. In other words, under the Old Republic treaty, could ITT Hamilton cancel insurance, even insurance in force, if it wanted to?

A. Yes, sir, that's my interpretation.

Q. I previously asked for your opinion as to whether it was proper for ITT Hamilton to—not to reflect unearned premium reserves under any of these treaties. Did you take into account, in reaching your conclusion, the fact that the Pilot and Na-

tional Fidelity treaties had this runoff provision which, as I understand, obligates ITT Hamilton to continue reinsuring policies that were issued before they canceled the treaty?

A. My definition of the unearned premium, on a retrospective basis, that's the amount of money, proportionate amount of money that must be retained at the valuation date for a period of coverage which had been provided for by the [30] premium itself, which had not expired at that date.

All of these treaties, even though they differ in the runoff provision, the premium payments received by ITT Hamilton were after the expiration of the period of coverage for which the premium was paid, and, therefore, by that definition retrospectively there could be no unearned premium reserve with respect to Hamilton, even though these premiums differed in that one respect.

There would have been a difference in the reserves or liabilities held by ITT Hamilton between these two—these two different type treaties, and that has to do with the reserve for losses, unpaid losses and unreported or—incurred but unreported claims.

In the case of the Pilot and National Fidelity, the ITT Hamilton would have held at any valuation date some reserve for claims that had already been incurred prior to the valuation date for which it had incurred claims but maybe notice had not been received, or in the case of claims where notices had been received but payments hadn't actually been disbursed, there would be a liability for those, and that's not true, though, with the Old Republic treaty, in which the Old Republic itself, the way it remitted premium payments to ITT Hamilton, they deducted in effect an incurred loss from the cash premiums transferred, so in effect Old Republic held [31] the entire liability with respect to losses, unpaid losses.

So they differed in that respect, and it is my understanding that the terms of these treaties were followed in their accounting and it seems that they did in fact account for loss reserves, as I have just described, in a different manner between the two treaties.

Q. Could you just very briefly tell us the difference between unearned premium reserve and an unpaid loss reserve?

A. Well, yes. The distinction has to do with the point of time. The loss reserves are for losses already incurred at the point of

valuation. The unearned premium reserves are for losses to be incurred beyond the point of valuation. One is a prospective point of view and one of them is retrospective.

Q. Well, Mr. Eddy, do I understand you correctly then that the mere obligation to provide insurance in the future, even if it is a binding obligation, to continue to insure for a certain period of time, does not of itself give rise to the necessity for an unearned premium reserve? Is that correct?

A. No, as a matter of fact, if this prevailed in individual policy life insurance, you would have the usual contract. The usual permanent policy provides for coverage throughout the man's life, and he may have just paid up one month's premium. So it would be unsound—it would be [32] impossible to have an insurance operation if the company were required to reserve for all future premiums had they not received the premiums. The unearned premium reserve in my opinion has not to do with the risk at a moment of time but has to do with the unexpired risk, proportionate to the premium paid or received, and that in fact is the way the insurance companies measure their unearned premium reserves, is to determine for every policy for which it has received a premium what is the unexpired period of coverage, and then they take a proportionate part in accident and sickness insurance—they take a proportionate part of the gross premium. In other lines of insurance they take a proportionate part of the net premium.

Q. Well, is it correct to say that you can't have, or no company would be required to set up an unearned premium reserve unless they had been paid for insurance which had not yet been provided as of the statement date, unless they had been paid for insurance to be provided in the future?

A. That's my opinion, yes, sir. I can't conceive of anything to the contrary.

Q. Mr. Eddy, is it conceivable that although a company would not have to set up an unearned premium reserve merely by reason of having an obligation to provide insurance in the future, that it might have to set up some other kind of [33] insurance reserve to reflect the fact that it was obligated, although it hadn't been paid for the insurance—it was obligated to perform it, rather to give it in some way in the future?

A. Well, there are types of insurance where you do have a reserve that is different from the—what's commonly referred to as the unearned premium reserve.

For instance, in individual ordinary life insurance contracts, your reserve requirements are defined both retrospectively and prospectively, and the reserves are equal whether calculated by either of these approaches.

Retrospectively it's very much like I have already discussed the unearned premium or the unearned gross premium on accident and sickness. It's a reserve or an accumulation of premiums paid for a period of coverage not yet expired.

Well, this is true in life insurance in effect, even though the reserves are referred to as tabular reserves or life insurance reserves as opposed to unearned premium. They are in effect a type of unearned premium. They happen to be on a net basis for life insurance, but on a level premium life insurance there is in effect an overpayment of premiums in the early years of a policy, which must be held, retained as if they were unearned, and accumulated at interest, until later in life when there is a deficiency.

[34] Now, in a retrospective basis, the reserves are defined that way. Life insurance policies, however, can have the reserves defined in a different manner, and that would be prospectively, and that is a method by which you ascertain the present value of your future liability, but you reduce that amount by the present value of your expected premium income. The net is your reserve or your liability. Well, these two, the retrospective and the prospective, would be the same.

Now, that occurs in life insurance. You would have a reserve if the premium payments under these contracts were on a single premium basis rather than on a monthly basis, or even if on some other premium basis than monthly, at the point of valuation ITT Hamilton had received any premium, any portion of which was to cover protection or provide protection beyond the point of valuation.

It just so happens in these contracts, or these reinsurance treaties, the provision is for monthly premium, and the monthly premium is received at the end—after the end of the month for the coverage, so that the premium that had been received at any moment of time was for coverages that had already ceased—had already expired.

Q. Well, I think as I understood part of your definition anyway, maybe it applies to both retrospectively or prospectively, but at least the prospective definition of an insurance [35]

reserve you would say that that would measure the excess of the present value of expected benefits that you would have to pay over the present value of future income or premiums that you expect to receive under the policy?

A. That's correct.

Q. Now, applying that kind of definition, if that's the proper definition, to the treaties here, did ITT Hamilton have any sort of actuarial liability under its Pilot treaty or National Fidelity or Old Republic treaty that should be reflected as the excess of the benefits over the future income?

A. Not in my opinion, because by almost any assumption as to future claims, you would find the excess of their premium expectations from companies like the Pilot and National Fidelity and Old Republic would have exceeded the present value of any probable claims that they would have, so you would have in fact a zero or minus, negative reserve, if you were to try to put a realistic valuation on it.

Q. So from an actuarial standpoint then, in view of ITT Hamilton policy holders and putting them on a sound actuarial basis, would you conclude that there was no need for ITT Hamilton to set up any sort of reserve under these treaties.

A. Well, of course, they weren't ITT Hamilton policy holders, they were Pilot policy holders, but there was no [36] need in my opinion for ITT Hamilton to put up any reserve to protect Pilot Life Insurance because Pilot and the other companies had held in fact the money that gave them this protection.

Q. But from an actuarial standpoint, I take it if ITT Hamilton, under these treaties and especially the runoff treaties, was obligated to pay Pilot and National Fidelity and Old Republic if the treaties weren't canceled, was obligated to pay claims under these treaties, and what I am really asking you is does this obligation, this actuarial obligation to pay claims, should it have been reflected in some way or was it proper from an actuarial standpoint, were they still a sound company even though they did not reflect the unearned premium reserve?

A. Yes, because they weren't obligated in my opinion to pay claims if they hadn't received the premiums from the companies involved.

Q. I see. But if you took these premiums into account, do I understand your testimony to be that the present value of the future premiums to be received under these treaties would at

least equal and would probably exceed the present value of the expected benefits, assuming that the premiums were paid when due?

A. If we were to use the prospective definition, we [37] would define ITT Hamilton's liability, that is precisely what I would say. It isn't normal to think in those terms with casualty type insurance. If you think in the retrospective, you really think in terms of how much of the unexpired period is involved and you set up a proportionate amount of the premium received for that period.

Q. Under that retrospective definition, would your conclusion be any different as to whether ITT Hamilton was required to set up some sort of reserve under these treaties?

A. In my opinion it is just more certain that there was no reserve, no unearned premium reserve.

Q. You mentioned earlier this historical fact, which appears to still be of some significance, that the unearned premium reserve is set up on a gross basis to provide for cancellation in the event of—provided for refund in the event of cancellation of a policy. Did ITT Hamilton, as you need the treaties here, did ITT Hamilton have any obligation to refund premiums to either Old Republic, Pilot, or National Fidelity, or to their policy holders?

A. Not according to this treaty, because any premium refunded by Pilot and National Fidelity and Old Republic to their policy holders was to be deducted from premium payments to ITT Hamilton from those companies, so there was no liability on the part of Hamilton to refund the premium. [38] Pilot, as an example, was to take any refunds that they made out of the premiums that they were going to transmit to Hamilton.

Q. Well, did any part—is it usual to refund—well, let me put it this way. How would you normally compute what would be due to a policy holder or to a ceding company in the case of a reinsurance treaty in the event of a cancellation of a policy, or premature termination?

A. Well, on the credit accident and health insurance, the general rule, under the general practice today, is for the insuring company to refund in the event of cancellation of indebtedness, or—not a pro rata part of the premium but a portion of the premium that had been paid by the policy holder, and is to

determine on the basis of sum of the digits. In other words, he doesn't get a refund of the pro rata portion of the premium he paid, but a reducing proportion.

Q. Does the portion that is refunded represent the earned premium or the unearned premium?

A. The portion refunded in essence represents the unearned premium.

Q. And then let me get back to say just between Pilot and ITT Hamilton, for example, had ITT Hamilton under these treaties received any premiums that it might be required to refund?

[39] A. No, not in my opinion. The premiums they have received is for coverage already expired, and you can't have a refund for coverage already—protection already received. Any refund has to be with respect to the future.

Q. And as far as ITT Hamilton's liability to policy holders, would you say that they had any refund obligation to Pilot's policy holders?

Mr. SCHWARZ. Your Honor, I object to the question. These are repetitive questions. They have been asked before.

The COMMISSIONER. Objection overruled.

A. Not in my opinion, no, sir.

By Mr. SINGER:

Q. Why not?

A. Well, because they have no contract between themselves and the Pilot policy holders. The policy holders are contracted directly with Pilot. It was Pilot's obligation to refund.

Q. Thank you. Mr. Eddy, are you familiar with the terms "reinsurance ceded" and "assumption reinsurance"?

A. Yes, sir, I am.

Q. Would you explain the meaning of these terms in insurance terminology.

A. Reinsurance ceded—it's referred to in other ways than just that, but here I think what you mean is that that's [40] an arrangement similar to the provisions that we have here. It is a contract between two insurance companies and it might be measured—the liabilities that are exchanged might be measured somehow in relation to individual policies of one of the ceding companies, but the contract itself is strictly between the insurance companies.

Assumption reinsurance is quite a different matter and it comes about when companies merge sometimes, or it comes about when one company will acquire the business of another company. The acquiring company, or surviving company in those cases, will issue a certificate of assumption directly to the policy holders of the company that is going out of existence, and it then becomes a contract between the reinsurer and the former policy holders with the former company, and after such an assumption of risk, the policy holders then deal directly with the reinsuring company. They are completely different types of arrangements.

Q. Can you tell us whether the treaties here, the accident and health treaties between ITT Hamilton and Old Republic, Pilot, and National Fidelity, were of the reinsurance ceded type or the assumption?

A. The reinsurance ceded type.

Q. Let's focus for a moment on the ceding companies. We have been talking about ITT Hamilton, but let's talk for a moment about Old Republic, Pilot, and National Fidelity and their situation under these treaties. You mentioned before that a company that has received premiums, which on the valuation date or the statement date represent in part at least insurance that it will have to provide in the future, has to set up an unearned premium reserve. Is this affected—or let me put it this way.

Under the Old Republic and Pilot and National Fidelity treaties, would the fact that these ceding companies have obtained reinsurance affect their obligation or under state law or under actuarial principles, to set up an unearned premium reserve, or could they eliminate the unearned premium reserve since they have obtained reinsurance under these treaties?

A. The Pilot and the National Fidelity?

Q. Yes, the ceding company.

A. Oh, no, they would have been required, as they were, to establish these unearned premium reserves if—incidentally, it is a very elementary concept, simply that they hold the money so they've got to set up and establish the reserve. If they had transferred the money and to the extent that they did transfer the money and any unearned portion of it was transferred at any moment of time, then it became the liability, the responsi-

bility of the reinsurer to set up the [42] reserve, but under these treaties the money was never transferred until after the expiration of the period of coverage. So the Pilot—well, they would have been—they would have been required by the insurance authorities of every state to establish the reserve.

Q. In your opinion, in your experience, have you ever heard of a situation in which a state regulatory authority required a company to set up an unearned premium reserve when they had not received premiums for insurance to be provided in the future? In other words, when they had not received an unearned premium.

A. No, I don't know of any such situation. I don't believe that exists. As a matter of fact, in my opinion the examiners of—all insurance companies are subject to an examination by the insurance departments which regulate them, and this might be restricted to one state, but to tri-state or regional areas if more than one state, but the examining actuaries would check in detail the contracts and policies in force at the valuation dates during this period, and had the company not established liabilities, these examiners would have restated their statements and established such liabilities.

Q. Are you talking about the ceding companies or——

A. In this case the ceding companies, yes.

Q. Well, can you explain in a little more detail how [43] do the state insurance departments keep track of whether an insurance company is maintaining the correct amount of reserves and so forth?

A. Well, through these triennial examinations principally. The insurance companies must report annually on this annual statement that you mentioned earlier, and it describes in great detail the reserves and assets, liabilities and assets of the company, but the real check comes on the examination, which the examiners get into very much detail.

Q. Mr. Eddy, we have stipulated here that, as I have already mentioned, that ITT Hamilton, the plaintiff here, filed its annual statements for '62, '63, '64 and '65, without showing any unearned premium reserves on its business with Old Republic, Pilot, and National Fidelity.

We have also admitted into evidence reports of the examination, I think of the type that you have just been talking about, of ITT Hamilton, audits of ITT Hamilton, dated December 31, 1964, and December 31, 1968.

Based on your experience, do you think it's possible that the insurance authorities having jurisdiction over ITT Hamilton would have taken no action to require ITT Hamilton to set up an unearned premium reserve if it was required under state law or under actuarial principles?

A. Barring an error on the part of the examiner, [44] I don't think so. I think they would have certainly insisted on establishing the reserve if they felt it was required.

Q. Well, I take it that the fact that these statements were submitted every year and that there were two examinations, would make the possibility of error pretty unlikely?

Mr. SCHWARZ. I object. I don't see how he can judge the possibility of error.

The COMMISSIONER. That is speculative, I think, Mr. Singer.

By Mr. SINGER:

Q. Okay. Apart from the field of reinsurance, is it possible for an insurance company to issue an accident and health policy which obligates it to provide insurance to the policy holder for a specific period of time, one year, two years, three years, at a specific premium, and still not—the insurance company would still not be required to set aside an unearned premium reserve?

A. Assuming that the company had not received premiums beyond the point of valuation or premiums representing periods of coverage beyond the point of valuation?

Q. Well, if that is a possibility.

A. Well, I can think of a very common example of that in group accident and health contracts which might be issued on a, say, a monthly premium basis, and the contracts call for [45] coverage, although cancelable, the coverage extends for a year or sometimes guaranteed for longer periods of time. But at the valuation date, which might be many months before the termination date, if the premiums are paid monthly, at the valuation rate the month for which the last premium was received has expired, there is no unearned premium in that case. That is a very frequent thing in the insurance industry.

Q. Suppose in this case, ITT Hamilton had issued a policy which provided for accident and health coverage as well as life coverage, over the period of the loan, and issued it to an individual debtor and charged the debtor a monthly premium, equal to, say, the monthly earned premium, which it received at the end of each month. Would it in these circumstances have been required to set up an unearned premium reserve?

A. No. As a matter of fact, there is that type of coverage in existence and it is frequently sold through savings and loan associations, but the insurance companies do not establish unearned premium reserves if it is on a monthly basis and the valuation date coincides with the expiration of the month or the monthly coverage.

Q. And these policies would be actuarily sound if you received the premium at the end of each month equal to the earned premium. Would there by any actuarial reason why these [46] policies would not be sound?

A. No, not generally.

The COMMISSIONER. Off the record.

[Off-the-record discussion.]

The COMMISSIONER. We will take a ten minute recess.

[After a recess, the hearing proceeded.]

The COMMISSIONER. All right, Mr. Singer, proceed.

Mr. SINGER. Thank you.

By Mr. SINGER:

Q. Mr. Eddy, I believe we spoke before, in our discussions about the unearned premium reserve, about the gross—we mentioned the gross unearned premium reserve and the fact that this contains a loading element and a morbidity element.

Now, Mr. Eddy, do you have an opinion as to whether it would be appropriate to compare a life insurance reserve with an unearned premium reserve, a gross unearned premium reserve, if the purpose of the comparison was to measure the risk assumed by a company on life policies or life benefits as opposed to the risk assumed by the same company on accidental and health benefits?

Do you have an opinion as to whether this would be appropriate?

A. Yes, I have an opinion. I think that that wouldn't [47] be appropriate if you restrict it to comparing the risk, to measuring a risk, because the gross premium obviously is for more than just the cost of carrying the insurance risk. It has to be for other purposes, too, as I have already mentioned.

Life insurance, by definition, is so-called risk only reserve and it is measured by statutory standards, but it is still something different from the gross premium, generally speaking.

Q. Is there a comparison that could be made that would be meaningful, to show what the dollar value of the life risk

of a company was, as opposed to accident-health risk, that could be used?

A. Well, if you used the morbidity element only in the accident-health and the mortality element only in the life, of course, you have to recognize interest to the extent of the period of coverage. Taking those things into account, you would have, at least to the extent you can compare the two benefits, you would have something comparable.

Q. Thank you. Mr. Eddy, have you examined the policies submitted by parties as Exhibits #10 through #16, which we submitted as typical individual and group credit life and credit life, accident and health policies, reinsured by ITT Hamilton during the years mentioned?

A. Yes, sir, I did.

[48] Q. Some of these policies provided both life, accident and health benefits in the same policy. Is this type of policy sometimes referred to in the insurance industry as a life insurance contract combined with accident and health insurance?

A. Yes, I believe you would consider that a combined contract.

Q. Could you go into some more detail as to what are the characteristics of a combined policy and the kinds of policies that have been issued and called combined policies?

A. Well, there is a great variety of these in the individual life insurance field. In the early part of this century, the companies frequently issued contracts that combined life insurance and an accident and sickness type of benefit. Those coverages would pay the face amount of the policy in the event of death, or if the man became disabled, they would provide for an installment of the face amount over a period of years.

Now, conceptually that's the same sort of contract that we are talking about here. In one event, that is, death, they pay the balance of the loan, and in the other event, in the case of disability, they would pay the balance of the loan in installments. So that type of policy has been in effect at least since the early part of the 1900's—the [49] combined type of policy.

The particular disability benefit somehow was not favored by insurance companies during the depression years as there was a great deal of abuse, at least they thought so, of that benefit, so that type of coverage sort of disappeared from the scene until, say, in the last fifteen or twenty years. It has now reappeared, but that's one type of combined policy.

In the weekly premium industry field you have a combination frequently of life insurance policies with other types of accident, sickness, sometimes hospital benefits, sometimes income benefits. The most striking, conceptually, is combined credit policy and the policy I described as being in existence in the early part of the century. They are the same. The only thing different is the period of time covered.

Q. When did these weekly industrial policies, if you know, when did they appear on the scene?

A. They have been in existence most of this century, too, and still are, for that matter.

Q. Mr. Eddy, do you agree with the statement that the term "non-cancelable life, health or accident insurance policy" means a health and accident contract or an annuity contract which the insurance company is under an obligation to renew or continue at a specified premium and with respect to which a reserve in addition to the unearned premium reserve [50] must be carried to cover the obligation? Is that an accurate definition?

A. Well, that's not my definition, but I believe a guaranteed renewable or non-cancelable contract is one which the company cannot cancel. I don't think that the reserves per se have anything to do with that definition.

The industry, through the National Association of Insurance Commissioners, has come to believe in the last couple decades that there is some need to set up an additional reserve for long-term non-cancelable life and health policies to recognize the fact that you are committed to a fixed premium.

Guaranteed renewable is not a fixed premium, but you are committed to continue, and this additional reserve they believe necessary to recognize the deterioration of health as age advances, so it is like the ordinary life insurance policy, where the premium is redundant in the early years, you must hold some back.

Now, the Insurance Commissioners did establish a definition which would divide policies or create a clear-cut line as to when they would require companies to set up an additional reserve, and when they would not, and this has become their definition of non-cancelable. As far as my understanding, it has to do not with reserves or whether the company can cancel or not.

[51] Q. What was the purpose of the Insurance Commis-

sioners drawing this line and saying certain policies are cancelable and certain are non-cancelable?

A. It is a recognition that came into existence of this potential need for additional reserves. This is all relatively new, of course, because the insurance companies generally discontinued accident and sickness insurance on a non-cancelable basis during the depression years because of the abuse that I was talking about, but after the war the competition has driven them back to issuing all sorts of such contracts and, of course, each and every year the commissioners become a stronger organization, as far as regulating, keeping the insurance companies under a statutorily solvent basis, so they have promulgated these regulations requiring extra reserves.

In my opinion it is an arbitrary provision because I think the rule goes something like age fifty, fifteen years, but they might just as easily have said fifty-five or forty-three or five years or twenty-five years, but it is a rule which they go by—most of the industry goes by.

Q. If an insurance company issued a policy for three years, providing accident and health benefits, does the risk assumed by the insurance company deteriorate during that period on an actuarial matter during the three year period?

[52] A. Unfortunately there is a deterioration as we age with respect to health and life, but generally speaking, it is the younger middle-age range—there is a deterioration, of course—it is very minor at those ages. but there is some deterioration.

Q. Would the company have to take this deterioration into account in setting the premium for a three-year accident and health?

A. Well, in my opinion I don't think so. I would suspect not. It would depend on age, of course. If the age were sufficiently advanced, maybe so, but generally I'd say no.

Q. Mr. Eddy, I would like you to tell me whether the following definition of a deficiency reserve is in accord with the accepted definition in the insurance industry: Quote, "The deficiency reserve for any contract is that portion of the reserve of such contract equal to the amount, if any, by which the present value of the future net premiums required for such contract exceeds the present value of the future actual premiums and consideration charged for such contract."

Is this consistent with the accepted meaning of this term in deficiency reserves in the insurance industry?

A. Right, with the additional provision there that we are talking about statutory future premium requirements as opposed to actual premium expectations or actual premium [53] charges. Yes, I think that is what it is understood.

The COMMISSIONER. I didn't hear you, Mr. Eddy.

The WITNESS. Well, as he read this definition, I failed to hear the reference to the statutory requirement for future net premiums in establishing reserves, and this deficiency reserve came about in about 1930 or along in that period of time, when stock companies began to sell insurance, where they charged the customer a premium that was smaller than the statutory net premium that is required to accumulate the reserves, and, of course, this came about because during that period of time the entire insurance industry, the life insurance industry, was using a mortality table which had been constructed or compiled in 1846 by one of the large mutual companies, and when constructed, it included certain measures of conservatism, and obviously, was quite outdated by the 30's.

So the stock companies, in their competitive efforts to get business from each other and from mutuals, would charge a smaller and smaller premium, adequate based on current mortality, but deficient compared to these redundant old, outmoded mortality tables. So deficiency reserves appeared in the statutes gradually and now exist in all—the statutes of all states as part of the standard valuation law.

To cause a company which sells to its customers an [54] insurance policy with an annual premium smaller than the statutory net premium, then the company is required at the moment of sale to set up the present value for the rest of the premium paying period of that deficit.

Of course, it's considered by almost everyone familiar in the industry, familiar with the industry, including the Internal Revenue Service, as not really a reserve but as setting aside or earmarking some part of surplus.

For instance, you cannot treat this deficiency reserve as—take it as a deduction from your taxable income, nor can you take investment income on it as a required interest to maintain reserves, and it's generally considered that way, but when he read this definition, I didn't get the word "statutory net premium requirement," and that's what I was trying to make clear.

By Mr. SINGER:

Q. So it is the difference between the present value of the statutory future net premiums and the actual—the present value of the actual premiums?

A. Right.

Q. Okay. Is it possible that a regulatory agency might require a company to set up a deficiency reserve on a single premium life insurance or annuity policy where the single premium is paid on the first day of the policy?

[55] A. Well, not by definition because the present value of future net premiums is zero and the present value of future gross premiums is zero. As a matter of fact, when companies are required to establish this deficiency reserve, this present value of the difference over the premium paying period, the reserves that sits on the books at the outset consists of the sum of the life insurance reserve plus this deficiency, and as each year passes towards the end of the premium paying period, a portion of the deficiency reserve is reduced as the life insurance reserve is increased.

So finally at the end of the premium paying period, under the deficiency requirements, deficiency reserve requirements, the deficiency reserve becomes zero and the life insurance reserve then is the total and only reserve required by law.

Q. Is there any analogy between the deficiency reserve and the loading portion of the unearned premium reserve?

A. No, I don't recognize any analogy between those two.

Q. Okay, thank you.

Mr. SINGER. That's all.

The COMMISSIONER. Are you ready to proceed, Mr. Schwarz?

Mr. SCHWARZ. Yes.

The COMMISSIONER. All right, proceed.

[56] Mr. SCHWARZ. With your permission, I would like to remain seated during my cross-examination.

The COMMISSIONER. You may, certainly.

CROSS-EXAMINATION

By Mr. SCHWARZ:

Q. Mr. Eddy, during the early part of your examination you discussed with Mr. Singer the kind of situation where a company assumes insurance in force but has not yet received the premium for that insurance.

Could you discuss with us, and one of the examples of that is this treaty with National Fidelity and with Pilot and with Old Republic—could you review with us each of the situations in your experience, besides the ones involved in this case, where that situation has come up and where you have considered the meaning of the term "unearned premium" or "unearned premium reserves" in that context.

A. Well, if I understand your question correctly, this involves maybe several dozens of companies, but to try to give you an illustration, I will name some specific companies, if that will be beneficial to you.

There has been—well, in recent times, at any rate—the requirement of most insurance departments in this country, that the reinsurer had to be qualified, or sometimes licensed in the state in which its companies who were [57] reinsuring with such reinsurer were domiciled.

Now, a lot of reinsurance is purchased through European markets and European reinsurers. Not all of them, some of the larger ones, have been licensed here for many, many years, but many of them also have not been, and in order to circumvent the problem which is created by the domestic company reinsuring, say, on an annual premium basis with a foreign nonadmitted reinsurer and being denied the deduction from its reserve liabilities the unearned premium held by the reinsurer on account of the unexpired portion for the period of time involved, at the risk it had reinsured, European reinsurers offered to sell reinsurance on a monthly premium basis.

Well, that practice has been adopted by a number of companies reinsuring in this country, and in fact, one of the most recent entrants into the reinsurance market is a company known as the Provident Mutual—excuse me, the Phoenix Mutual, in Hartford, and they have been in the business quite a few years now, and I don't know how many customers they have. Many of my clients bought reinsurance with them, but regardless of the premium payment basis between the client companies and their customers, with the policy holders, they reinsured and paid premiums to the Phoenix and Occidental of North Carolina, Victory Life, Occidental of England—many others [58] I can't think of on the stand here—they reinsured on a monthly basis.

Now, the reinsurer was not—although they were committed to the contract and they couldn't cancel the contract, they had

no unearned premium reserves beyond that month's premium. Their valuation date fell, as it does, on December 31, and their premiums were collected throughout the month of December. They would have had a half of one month's premium as a reserve, but this is a common practice and the type of reinsurance you are talking about here, where in effect you have a combination——

Q. Excuse me. Are you going back to these policies now?

A. Yes.

Q. Could I just talk to you for a moment about the example you have given? I will try to take each one separately.

A. All right.

Q. You mentioned that the practice that you just described arose because of the requirement in many states that the reinsurer be licensed or qualified to do business in the domiciliary state of the insurer; is that right—in order for the insurer to get credit for unearned premiums transferred to the reinsurer?

A. In order for the credit to be given, that's right, [59] yes.

Q. Now, does this suggest, first of all, a practice whereby an insurer who, at least to use your opinion of the situation, pays the full premium on reinsurance at the outset of the coverage to a reinsurer, will be allowed a credit for its unearned premium reserves by the insuring state, if in fact that reinsurer has been qualified to do business——

A. And if there is a premium transfer.

Q. I said the premium would be transferred.

A. In the event the premium was transferred, then that's right, yes.

Q. Okay.

A. Of course, there were other reasons for this type of reinsurance, which you can appreciate, other business reasons. For instance, the reinsuring company—and I hope I don't inadvertently use terminology which is exactly opposite from the way you are thinking, but the company ceding, obviously, would be more pleased if it could collect premiums on an annual basis from its policy holders and remit monthly to the reinsurer.

Q. Would pay for that?

A. Well, competition in fact keeps it down to a minimum cost, if any, or it's not measurable. It's not anything direct or obvious. And because of the cash flow—and this [60] is particularly true with smaller companies, and their images mean a lot to many life insurance companies, if not all of them—

they like to see better balance sheets and better cash balances, so this is one of the reasons.

Q. Now, if the effect of the credit that you referred to would be that the unearned premium reserve which, before the reinsurance, had to be held by the insurer, would be deleted on its annual statments, and the reinsurer, in the example I gave you, would be required to reflect an unearned premium reserve on its annual statement——

A. And you referred to the example you gave, emphasis on the fact that it was an annual premium from the ceding company to the reinsurer.

Q. Yes, that's the example I gave.

A. That's right. Of course, I have to qualify that and say that in the event that the period of coverage for which this premium had been paid had run, there would be no unearned premium, no credit either way, no credit nor reserve.

Q. Now, in the same example that you gave, suppose the reinsurer were not qualified to do business in the state, or were not—or it was not licensed to do business in this state. Would the insuring state permit a credit to be given?

A. Well, you have to accept this as a hypothetical answer to a hypothetical question because generally companies [61] are too smart to deal with reinsurance with which they can't get credit. But assuming this could happen, then the ceding company would be denied the deduction for reserves held by the reinsurer.

Q. And would the domiciliary state of the reinsurer require it to reflect an unearned premium reserve on its annual statements despite the fact that the insuring state also showed an unearned premium reserve because of the denial of its credit?

A. That situation can exist if companies would do it, that would be true. No, I am not sure I am answering the question right. I will state it as it should be. The reinsurer would have to establish the reserve because in the insurance industry the liability for an unearned premium reserve depends on whether you've got the money or not, and in the case, the illustration you were giving, the reinsurer has received the money, so from a mathematical or equitable point of view, they have the unearned premium reserve no matter whether the ceding company could have taken credit or not.

Q. So the situation does exist then when two unearned premium reserves could exist?

A. Oh, I can't say it exists.

Q. Well, it could exist?

A. It depends on the business acumen, of the people [62] involved, but I would say generally that doesn't exist in practice. It could exist in theory.

Q. Why would an insurer be interested in obtaining a credit for its unearned premium reserve besides the—I suppose the most obvious fact is that it doesn't have the premium—I assume that would be the first part of it. Besides that?

A. Well, of course, despite the fact that the insurance industry is regulated with an emphasis on protection of policy holders and, therefore, reserves are normally established at a very conservative level. There is an endless effort on the part of all parties involved to properly account in your balance sheet for your liabilities and for the other guy's liabilities. Now, in spite of—ignoring anything else, it would be, accounting-wise, totally inaccurate not to take credit if in fact the reinsurer had taken the premium and it was responsible for holding the reserve.

Q. Apart from the questions of forms involved in accounting, what substantive reasons might an insurer rely upon? Why might it want to rid itself, so to speak, of an unearned premium, especially if the effect would be to increase surplus, as it would in the example that you gave?

A. Not necessarily, it can and it cannot, but the example I was thinking of, as I spoke—I didn't visualize any surplus. As a matter of fact, generally speaking, we are [63] talking about the reserve carrying an insurance risk on an unearned basis. What you are really doing is, if you transfer the reserve from one company to another, it's a result in practice of transferring an asset, namely, the premium. So if the guy that has the asset, he also holds the liability. At the moment of transfer on the cost of carrying the risk basis only, they are exactly the same. The amount of money that you pay is exactly equal to the reserve at that moment, so there is no gain or loss in that situation.

Q. I am not referring to gain or loss necessarily, but tell me what the normal effect is on an insurer upon—on an insurer's assets, reserves and surplus, of reinsurance of busi-

ness. Now, let's take a—if "normal" bothers you, we will take what I would hope would be a normal example, and correct me if I am wrong. An insurer receives—agrees to reinsure, let's say, three year straight age policies, and it receives all the premiums, three years worth of premiums for those policies at the outset of coverage. It then enters into an agreement with the reinsurer whereby it reinsures 100% of its liability with the reinsurer and it pays the reinsurance premium, which I would think in a normal case would be—and it would be in this case—would be something, say, a little less than the original premium to provide a commission of some sort for the insurer,—pays that amount to the reinsurer, [64] at which time the reinsurer assumes the liability on the risk for the three or four years, whatever the policies are. Now, in connection with that transaction, the insurer would normally pay commissions to the agents who brought in the insurance, isn't that right?

A. The ceding company?

Q. Yes.

A. I think you are using the term "reinsurer" interchangeably and it is confusing me.

Q. I will use ceding company.

A. Okay. If you are talking about the ceding company, there are different circumstances—there are occasions when insurance companies get business without commissions, but the normal case is that a commission is paid, yes.

Q. Okay. Then we will pursue this normal example. The commission that would be paid would—is usually a significant portion of the premium. I realize it can range over quite a broad spectrum, but it is significant and it is paid at the outset of coverage in my example, is it not?

A. Now, the word "significant" needs to be qualified if we are talking about different types of insurance. For instance, the customary commission on single premium life insurance is in the neighborhood of two or three per cent. If you are talking about annual premium, which is in effect [65] another way of paying the single premium, companies make it convenient for people who are buying insurance by making an annual premium basis available. Then the commission, a percentage of the first premium, is substantially more. It may be in the neighborhood of fifty, it may be even a hun-

dred per cent in many of the stock companies, taking all levels of salesmen into account.

That is still, if you would take into account all of the premiums, although it's a large percentage of the first one, you are still talking about maybe something averaging quite much more over the entire period of the contract since renewal commissions are substantially lower, but I just want to make it clear that—you said it was a wide range, and there is, of course.

Q. Are you aware, for example, that the commissions involved in the Pilot and National Fidelity treaties and those paid by the insurer were between twenty and thirty per cent of the premium?

A. Well, I don't have that fresh in my memory, but I have read those agreements.

Q. Well, they weren't in the treaties, nor in the policies. That's why I ask you now. I understand——

A. Whatever was in the treaties, I suppose that's the only thing I have to go by.

[66] Q. We talked about stipulating those figures.

Mr. SINGER. Mr. Eddy doesn't know those figures. We haven't stipulated to them, and they are not in evidence.

By Mr. SCHWARZ:

Q. Okay. So a commission, whatever it would be, would be paid at the outset. What might be the commission, a typical normal commission on a three year age policy? What would its percentage be of the total premium?

A. I don't know that there is any normal, because you have a complete range from zero to—I would expect on accident and health—generally, and accident and health credit insurance—is this what we are talking about?

Q. No, regular accident and health policy.

A. Not restricted to credit?

Q. That's right.

A. Well, then probably the range could be from zero to thirty-five—forty per cent.

Q. Okay, let's say it's twenty per cent for the purposes of the example.

A. All right.

Q. So the insurer, the ceding company, pays a commission of twenty per cent. It receives a premium of a hundred per

cent, remits a reinsurance premium to the reinsurer, which is somewhere in the vicinity of a hundred per cent, maybe [67] ninety-eight, maybe it's ninety-seven—something like that. Now, given that example, what is the effect on the assets, reserves and surplus, of that transaction, as far as the ceding company is concerned?

A. Well, in the example you are giving here, let me restate it to make sure I understand it. The ceding company has held a policy and it's received a premium, a three year premium.

Q. Okay.

A. Then it has paid a twenty per cent commission, you say? Then on its books immediately it would have had, in the income statement, income of—let's make it a dollar premium, for convenience—a dollar premium income, a twenty cent disbursement for commissions, and if it is an accident and health coverage, the statutory reserve would be a dollar reserve. So as far as the income statements are concerned, we've got a net loss of twenty cents. The balance sheet would show assets of eighty cents, liabilities of a dollar.

Q. You said there would be a loss of eighty cents?

A. A loss of twenty cents.

Q. You have a dollar of income on the income statement, less twenty cents commission, that would be an income in effect of eighty cents.

A. Net income, yes.

[68] Q. All right. Now, the asset would be eighty, the reserve would be a dollar?

A. Right.

Q. And the effect on surplus would be what?

A. Well, as I have already said, your loss would be twenty cents and your balance sheet would show a dollar and eighty cents respectively, thereby surplus would be minus twenty cents.

Q. Okay. Now, what is the effect on that statement of reinsurance under the example that I gave you?

A. Well, there is a difference in practice in the United States. It's not clear-cut at the moment, in my thinking, as to where it is going to end up. At the moment some states would require one of——

Q. I am asking for the normal practice. I realize there are always differences.

A. I can't say. It may be pretty evenly divided between the states at this moment of time.

Q. Was it divided during the years in suit?

A. As a matter of fact, more specific than the years of this suit, I believe the prevailing practice was this, that the ceding company would have reinsured the risk and the reinsuring company would have received—let's suppose a hundred per cent for the sake of argument. Barring any sort [69] of compensation to the ceding company for the moment, the ceding company would have reinsured, say, a hundred per cent of the risk. They would have transmitted to the reinsurer eighty cents, and the reinsurer would have established as their liability on the basis of their gross, an eighty cent reserve. So there would be no gain or loss to the reinsurer at that moment, and there would be no change in the account of the ceding company.

They would be out—their balance sheet would be different because they would have eighty cents less assets, but they would also—I beg your pardon—it would have made a twenty cent increase in their net worth because they would have got rid of a dollar reserve with the eighty cent premium.

Q. Is their practice whereby the reinsurer would set up an unearned premium reserve for one dollar rather than eighty cents?

A. Subsequent to the time that you are talking about, there has been concern amongst the insurance commissioners to the extent that it is generally accepted—I am not certain, but there has been a change of practice which has required the reinsurer in the example we just talked about to establish a dollar reserve rather than eighty cent reserve. But during the period of the time of this case, it was really the other [70] way around.

Q. Are you familiar with the examiner's handbook of the National Association of Insurance Commissioners?

A. Somewhat, yes, sir.

Q. Are you familiar with the Section B in that handbook on reinsurance?

A. What page number?

Q. Well, if you are familiar with the section, we can then become more specific as to the page.

A. I am familiar with the section.

Q. This is a Section B, is a reference from the 1961 NAIC proceedings, Volume 1, pages 147–177.

Mr. SINGER. Excuse me. Is there any way we can have a copy of that, or see what he is talking from?

Mr. SCHWARZ. I am not offering this into evidence. They can see it if they would like. I am just asking—stating something from it, and asking whether he is familiar with the statement. Now, if they want to review it, they are quite——

The COMMISSIONER. For convenience, you don't happen to have an extra copy, do you, Mr. Schwarz?

Mr. SCHWARZ. Well, I believe——

The WITNESS. I would be glad to have a copy, too.

Mr. SCHWARZ. Does opposing counsel have a copy [71] elsewhere?

Mr. SINGER. I don't think we have it here.

Mr. SCHWARZ. The copy that I have is——

The COMMISSIONER. Off the record, Mr. Reporter.

[Off-the-record discussion.]

The COMMISSIONER. On the record now, Mr. Reporter. We have been off the record while you were discussing the copies.

Mr. SCHWARZ. Perhaps Mr. Eddy would want to ask again what he thought I was doing.

Mr. SINGER. Could I ask that the witness be shown this?

Mr. SCHWARZ. Certainly.

Mr. SINGER. The one you are referring to.

[Article referred to the witness.]

By Mr. SCHWARZ:

Q. I was referring to this heading on page B–14, and I am asking you about this sentence which is my understanding of what the normal practice is, and it seems to differ, if I understand you, from your statement of the normal practice.

A. Now, without reading it, and I think I am familiar with it, you are talking about excerpts from proceedings of '61. Well, these things take many years to become enacted as either statute or become regulations in the various [72] individual states that are involved, and I don't find, as I say, subsequent to the period in question here, it is my belief that states generally have been accepting this proposal of the NAIC.

Q. This was not a proposal, this was a statement by way of information of what the normal——

A. That has not the effect of regulation, that's just what they collectively think they should do. It's quite another matter for them to go back to their home states and to implement these common understandings. In fact, in many cases where they have requirements of statute change, you can't do it immediately because states only have their legislature in sessions biannually, so when it appears in their transactions in '61, it doesn't mean it was immediately effective.

I just happen to know, from my own personal experience, what the practice was in 1963, and I do know for a fact that some states that I happen to be interested in, in my occupation, made a transition during that period of time, and in fact the companies that I have been involved with during that period of time, but I also know in general it hadn't become effective.

Now, to answer you as if these proceedings had become effective regulations throughout the country, then [73] the fact of the transaction that we were talking about would have been to have given the ceding company a twenty cent increase in the surplus, probably reflected as income, depending on how it was handled accounting-wise.

Q. Okay.

A. And likewise, the reinsurer would have had a twenty cent decrease in surplus because it would have received presumably the eighty cent premium for which it established a dollar reserve.

Q. Okay. So would an insurer or ceding company interested in increasing its surplus for any reason insure under the example that I discussed with you, presuming the state that we are talking about does grant the credit, presuming the effect to be of increasing the surplus by twenty cents, as you stated in your example,——

A. Would the ceding company be interested in anything other than such transaction that we discussed?

Q. Yes, I am just affirming what I understood you to say before, that an insurance company, desirous of increasing its surplus, might do so under an arrangement which we have just discussed.

A. Yes, but, Mr. Schwarz, I feel compelled to point out to you that what we are discussing as increasing is not anything real.

[74] Q. I am not concerned with the reality, I am asking you——

A. Well, but I can't answer the question in that context. I have to say it as I see it.

Q. I am asking you to tell me whether the company, after doing this in a state which permits it, could then show an annual statement or a financial statement which would have a higher surplus than it did before.

Mr. SINGER. Excuse me, Your Honor. We have gone along with this for a while. I submit I don't understand where this is going. This doesn't relate, as far as I can see, to the treaties between ITT Hamilton and the ceding companies in our case, and I would like to object at this time, unless Mr. Schwarz can tell us where he is going as to the relevancy of this line of questioning.

Mr. SCHWARZ. Your Honor, plaintiff's direct examination covered the entire insurance industry and discussed examples ranging from life insurance to industrial accident insurance. I am also pursuing industry practice, and I am asking about a particular industry practice at the moment, and in that context I am discussing the effect of the practice on unearned premiums and unearned premium reserve, which I believe is a rather crucial point in this case.

The COMMISSIONER. All right, objection overruled.

A. Well, that practice wasn't common. You have to [75] understand that because whereas——

By Mr. SCHWARZ:

Q. Mr. Eddy, I am asking you a specific question and I would like to get a specific answer. The question was under the arrangement that we just described, the example that I just posed and that you clarified, if a company desired to increase its surplus on its annual statement or on a financial report, could it not do so by twenty cents if it followed this example?

A. Well, I have already answered that, I believe.

Q. What was your answer?

A. Well, to repeat myself——

Q. Can it or can it not?

A. I said it increased to twenty cents.

Q. Okay, fine. Now, getting back to the first example you gave in response to my question about the various contexts in which a premium had not yet been received by a company which had accepted insurance in force, could you describe in somewhat more detail the kinds of reinsurance treaties you were referring to, and again a little bit about the kind of insurance that was being reinsured under these treaties.

A. Well, I believe that during my experience, I have probably seen many insurance agreements that covered all types of life and accident and health insurance, and I may be hard pressed to name by individual companies at this moment where [76] they did exist and did not exist, but I have seen many contracts of individual policy life insurance and individual policy accident and health insurance, credit insurance, both individual and group, both life and accident and health, reinsured on a basis similar to what we are discussing here with respect to these companies, namely, that the premium arrangement between the ceding company and the reinsurer was on one basis and the premium basis between the ceding company and its policy holders was on another basis.

Q. Okay. Well, let's go through the various types of insurance that is covered and the various types of reinsurance treaties that would result under those forms of coverage with a view toward describing basic terms most simply. You started off with an example of individual life policies, which are then reinsured. Could you describe the basic elementary terms of these life policies first?

A. Well, they would range from—well, the entire type, range of types of policies, individual, ordinary life insurance or whole life insurance, which implies that the coverage is for the entire life of the individual insured.

Q. Let's take that example.

A. All right.

Q. Under that example, does an insured normally, if you will, pay an annual premium in order to purchase a whole [77] life policy which will provide him with the face amount upon his death?

A. Well, "normally" is a difficult question to answer. Very frequently the insured does that, yes.

Q. Is the premium normally stated on an annual basis? If I go to an insurance agent and I say, "I want to purchase a whole life policy for $100,000, what's the premium?"—what is he going to say?

A. Well, I think invariably the premiums are stated on an annual premium basis. Other plans are offered.

Q. I understand that. Let's take the case of an insured who takes out a whole life policy with an annual premium. When does he pay that premium? He is not paying it in installments now, he is not electing, as I understand he would be able to. When would he normally pay the premium?

A. Well, the premiums are due when they issue the contract.

Q. They are due when the contract is issued?

A. Right.

Q. I see.

A. Of course, there are provisions today required by law which give the man subsequent premium payments after the first, a grace period.

Q. Okay, let's not move too fast. We are just talking [78] about the first premium now.

A. With respect to the first premium, it is the general practice that insurance companies in fact do issue the policy and they do become committed to the risk in a contractual arrangement at that moment of time, and then the policy holder pays the premium whenever he receives his policy. There could be a lapse of time of several weeks—maybe thirty days.

Q. We are talking about a short period of time that arises in practice between the time that the premium is required to be paid and the time that it is in fact paid, in practice.

A. Right. Currently the competition on new policies of this period of about forty-five days, that's pretty common today, and then through practice companies allow for maybe another couple of weeks, and this is more for administrative purposes or convenience than anything else before they actually implement the lapse process.

Q. Does a binder take care of something of this——

A. You can have binders and you can have other—you can have insurance issued without—you are talking about a binding receipt, some money received at the time of the application—is that what you mean by that?

Q. Yes.

A. It's issued both ways.

[79] Q. All right. So in a typical case the premium is required at the start, the annual premium is required at the time the policy goes into force, and again it may be paid a little before, a little after, depending on the practice. Now, at the end of the year the company sets up a life insurance reserve. How does it measure that reserve?

A. Well, it measures this life insurance reserve either by the prospective or the retrospective method, which I have mentioned before.

Q. You don't have to repeat it.

A. You don't want me to repeat that?

Q. No.

A. All right.

Q. Now, what happens if the policy holder does not pay his annual premium at the beginning of the following year or within the grace period that is allowed under the policy?

A. His policy is canceled.

Q. Is he advised of this?

A. Generally speaking, yes.

Q. You mean he might not be advised?

A. He's got to be advised because his contract says he has to pay it within the grace period.

Q. The policy?

A. Yes, there is a provision in the policy that [80] terminates it. The companies, through practice, may or may not notify the insured. There are non-forfeiture benefits, and if the policy has been in force long enough that it has a refund benefit, a non-forfeiture benefit, then the companies would put the man on notice that at the expiration of the non-forfeiture benefit—that's, of course, to make sure he understands his coverage has not ceased.

Q. Okay. Now, this type of policy can be reinsured?

A. Yes.

Q. Is that correct?

A. Yes.

Q. Would you describe the basic terms of a reinsurance treaty, for the reinsurance of this particular policy. Again we have talked about an average, a normal whole life policy, and I am asking you now about a normal reinsurance treaty, or if there are a couple of varieties——

A. Well, there are more than a couple of varieties.

Q. I am sure of that.

A. The most common would be—well, generally speaking, reinsurance serves the major purpose of spreading the risk. It really, in the life insurance industry, is never considered a transfer of the liability on any permanent long-range basis. People would be naive to think that reinsurance companies were in business other than to make a profit.

[81] So that what they are doing is they are offering a service, a service which is to level out claims rather than have a company experience, say, a chance fluctuation and an unexpected large claim.

Q. Why aren't they long-term arrangements? I didn't understand your response there.

A. Well, in the long-range, all insurance companies, unless they fold up before the things level out, pay their own claims. The direct policy holders ultimately are paid out of the funds of the issuing company.

In interim periods of time, through reinsurance, unless we've got an assumption of the risk or we have co-insurance, which is a variety we haven't been speaking of here, the reinsuring companies only in effect are leveling out the claims experience of the ceding company.

Q. Would the normal provision of the reinsurance treaty permit the—when the insurer, the ceding company, got large enough, say, to be able to assume the risk which it's reinsured, how would it go about doing that in a normal situation?

A. Well, there are differences in practice there. Competitive pressures generally cause companies in recent times to assure the ceding company that they could recapture these risks under certain terms and conditions after certain periods of time have run. Of course, the main purpose there [82] is for the reinsurer to make sure it has had an opportunity to recover and not have to have a recapture right after the occurrence of some big claim.

Q. So the reinsurer might be able to cancel his reinsurance for some future period, for some future year?

A. Are you talking about the ceding company now?

Q. Let's say the ceding company pays an annual premium to the reinsurer much the same way as the policy holder paid an annual premium to the ceding company.

A. Yes.

Q. When the next premium became due, under a normal situation, the reinsurer would be able to cancel by not paying the premium; is that right?

A. The ceding company?

Q. The ceding company.

A. If the policy is lapsed, you are saying?

Q. Yes.

A. Or referring—yes, it would—it's all automatic and by agreement. The terms of the agreement say that when the ceding company's liability ceases, the insurer's liability ceases.

Q. And normally it would be able to cause the policy to lapse by failing to pay the premium, or giving notice?

A. Or terminating for other reasons.

[83] Q. Okay. Now, since that is the case, a reinsurer would not assume expenses beyond those which he could expect to be compensated for in some way or another out of premiums he received, an annual premium, is that it? For example, for some strange reason if the ceding company paid the agent the full commission that he would earn if the policy holder continued paying his premiums for his full life at the outset, a reinsurer is not going to agree to pay that commission to the ceding company, pay it back to the ceding company or to have the premium which it receives reduced by the amount of the lifetime commission, when it's only receiving one year's premium?

A. Oh, yes. You see, we are talking about life insurance. I think you've got a misunderstanding because in life insurance, generally what you are reinsuring is the mortality element only, so the premium that you are transmitting from ceding company to reinsurer is not the gross premium but it's the cost of carrying the insurance risk.

Q. So it is the current premium?

A. I beg pardon?

Q. It's like a current premium, right? It's a premium covering the period—in other words, it's the current portion of the premium and not the portion that has to be set aside to provide for risk which is going to arise in the future, [84] that is, the reserve portion.

If I get a premium—if I am a ceding company and I get a premium of a hundred, I am required—some part is expenses, some part is put aside as a life insurance reserve, is that right?

A. I need to go back if I could to this concept of the arrangement between the insured and the ceding company, is on one basis.

Q. Yes.

A. The arrangement between the ceding company and the reinsurer is on another basis. Now, the arrangement between the ceding company and the reinsurer, on a normal reinsurance of life insurance, is only to deal with the cost of carrying the insurance risk generally in some amount above what the ceding company considers its safe level of risk.

Q. I see.

A. The amount above that safe level is the amount of reinsurance for which the ceding company pays the reinsurer, not of a premium that has any redundancy in it, which the reinsurer then is obligated to accumulate with interest on the same basis that the issuing company is accumulating excess premiums in the early ages from its direct policy holders, but only the premium that is necessary for the period of coverage for which the premium is intended.

[85] Q. I see.

A. On an annual basis if it is annual, a monthly period if it is monthly.

Q. Now, this example you are giving me is typical of the kinds that you referred to in your first example in response to my introductory question? Is this one of the examples?

A. Well, this is one of the examples, and originally what I was referring to was the modes of premium payment and not the types of insurance.

Q. Well, you were referring to a particular type of mode in the example when you first responded to my question; is that right? The types of modes. Was the example that we just discussed one type of those modes?

A. The mode to me refers to the method of premium payment.

Q. That's right.

A. Okay. I was explaining a reinsurance arrangement which could encompass different modes and not specifically in this discussion talking about a particular mode.

Q. My question was, my original question was that I wanted you to review in specific detail all the various types

of situations you have come across, or convenient examples of all of them where a premium had not yet been received, [86] although insurance was in force with the company that had not received the premium. Now, that's not the case in the example we just discussed, is it? The annual premium is received at the beginning of the period, isn't that right?

A. Mr. Schwarz, I think I may be confused by your questions. The explanations of reinsurance, which I was attempting to give, didn't have to do with the timing of premium payments or the mode of premium payments. There are all sorts of arrangements that exist in practice. About the only thing that doesn't exist is the payment of premiums by the insured after the period of coverage is expired.

Q. Do ceding companies pay reinsurers after ceding?

A. Between corporations, all sorts of arrangements exist, and timing is something that is a mechanical problem with most insurance companies. For instance, companies dealing with, say, the Phoenix Mutual—I named them because they are strictly on a monthly mode basis with their customers, because of the volume of details involved, and each of these premiums is measured on an individual policy basis. Sometimes it takes them a period of weeks or maybe their entire monthly cycle, but on the other hand, you can find situations where all of the accounting initiates with the ceding company and they transmit the premium right from the outset, sometimes before they collect the premium.

[87] Q. On the tremendous volume of business of Provident Mutual that you are referring to, where they may be taking reinsurance on a monthly basis but the ceding company has received the premium on a yearly basis, say, can the ceding company terminate those policies by failing to pay the next month's premium?

A. Sure, and they would if the policy terminated for some reason.

Q. Okay.

A. I might add that the normal arrangement between reinsurer and ceding company on any type of insurance is that the premium isn't paid beyond the point the coverage terminates, whatever that coverage might be, and for whatever reason they may terminate.

Q. The premium is not paid beyond——

A. The termination of coverage.

Q. Now, on the other hand, normally premium is paid at the outset of that particular coverage; it won't be paid for a period in excess of the period of coverage, but it is paid at the outset, or shortly before, shortly after; is that right?

A. Yes, generally speaking, in an accounting period it would be annual or less. Sometimes reinsurance is made for a single premium transfer, but that only occurs, of course, with single premiums. There aren't any advanced premiums, [88] generally speaking, in the reinsurance.

Q. Again my question was to give examples where coverage was in force but premium has not been received. Now you tell me that the normal practice is in this Provident Mutual case, which you suggest is typical, that the monthly payment——

A. It's not Provident Mutual. They are a very large company, but they are not the one I am referring to with this reinsurance arrangement. I am talking about Phoenix Mutual.

Q. I am sorry, Phoenix Mutual. Okay. But that doesn't seem to be an example of the sort that I am asking for. There they pay a monthly premium, they get monthly insurance. They don't pay the next month's premium, they don't get the next month's insurance. Now, there may be a couple days delay in paying the premium, but basically that's the rule, is it not?

A. That's right.

Q. All right. Does the situation ever arise again, to ask my basic question—do other situations arise where a company will assume insurance for a period of years, well before they collect the premium for that insurance? That is, assume an unconditional obligation to provide coverage.

A. I don't believe that would be fundamentally sound, and I don't think it would be permitted.

Q. Could you give me your understanding of the meaning of the term "surplus aid contracts"?

[89] The COMMISSIONER. Surplus what?

Mr. SCHWARZ. Surplus aid.

Mr. SINGER. Could I ask again what the relevance of this is to our case?

Mr. SCHWARZ. Yes, perhaps after Mr. Eddy describes the contract, the relevance will become apparent.

The WITNESS. I could answer now, but——

The COMMISSIONER. All right, we will allow lenience in cross-examination. Go ahead, Mr. Schwarz.

Mr. SCHWARZ. Thank you.

By the COMMISSIONER:

Q. Do you remember the question?

A. Yes, sir, I do remember. There are a variety of such arrangements. Generally speaking, conceptually, what is meant by that, is that through a reinsurance or a co-insurance contract, one company is able to improve the surplus position of the other company. Generally speaking, that flows from the reinsurer to the ceding company. Not always.

By Mr. SCHWARZ:

Q. That is, the ceding company surplus will be improved by the reinsurer?

A. That's the general situation, yes. It could go the other way, through special types of arrangements. Now, the way this comes about, it's been in existence probably as long [90] as the major reinsurers have been in existence. In this country, when you sell insurance, individual policy, annual premium contracts, the competitiveness for salesmen is such that you pay a large commission the first year, we have already discussed, maybe up to a hundred per cent. And because when you make the sale, you've got to go through an underwriting procedure and you've got a certain amount of staff and overhead that is involved with nothing except establishing the policies on your books, you have a net in effect of more outlay than you get in premium income in the first year.

Now, because of the accounting requirements and the statutory provisions or the regulatory authorities, the insurance company is caused to charge off all of its expenditures in the year of issue, and, of course, it only includes in its income this premium.

Smaller companies, and since World War Two there have been a real outgrowth of such companies, are establishing themselves, say, with minimum capital by state requirements, and they find that this drain, if they are successful in

selling, rapidly depletes their capital and surplus—statutory capital and surplus.

So in the competition for reinsurance business, the large reinsurers, Lincoln National, the Phoenix Mutual, North American Reinsurance, Businessmen's Insurance, others that do [91] not come to my mind just this moment—they offer to help these companies along, which they don't refer to it as surplus relief, but in fact type of reinsurance or co-insurance agreements where they in effect substitute for the smaller companies in this first year position. They do that through co-insurance arrangements, becoming—taking the burden of the first year expenses in excess of the first year of premium income.

Now, because life insurance premiums are established so that even though you have this drain the first year, or this burden the first year from a statutory accounting basis, the premiums are established so that as the years go on in renewal, you get sufficient amounts in excess over the years to repay you this deficit with a reasonable return.

Q. Before you go to the reinsurer, let me just interrupt. If a company pays a commission on life insurance, it pays it with the understanding, if it pays it on an annual premium that is received, let's say it pays that commission with the understanding that the policy holder may not continue his insurance the next year, by not paying the premium, is that right? So it's aware of that contingency, right?

A. That's right.

Q. And if the policy holder canceled his policy during the year for which he had paid the premium, the agent is often required to in effect remit a portion of the commission [92] relating to the unexpired term by having his commission the following month reduced by a return commission, in effect?

A. No, that practice is not in existence in the life insurance field. The policy holder does not have the right to cancel during the period for which he has paid the premium. He can cancel by not paying another premium, but there is no provision either to refund the commission to the policy holder or to reclaim it from the agent. So what you suggest doesn't exist.

Q. I see. Okay. Now, can you go to the effect on reinsurance?

A. Well, all right. The reinsurer substitutes in effect for the ceding company in this drain of—this surplus drain position. Of course, the co-insurance agreement really just caused the income from the policy holder to flow right through to the reinsurer, also the disbursements to the agent and other people in effect flow right through to the reinsurer, both first year and renewal.

So that the knowledgeable reinsuring companies, they know that they, in all probability, will get back this drain with a reasonable return on their investment, and that's the type generally, a concept—that's what all surplus type of reinsurance, surplus relief type of reinsurance accomplishes.

Q. But the insurance that is reinsured is between the [93] policy holder and the ceding company, is that right?

A. No, no, the—well, excuse me.

Q. The reinsurance referring to is reinsurance of business written between the ceding company and the policy holder.

A. That's right, but the agreement, of course, the arrangements are not between the reinsurer and policy holder but between the reinsurer and the ceding company. Actually in this type of co-insurance, it appears to have a bad connotation.

Q. Let me just get to this one question and we will get to the connotations. I am not trying to create bad connotations, I am just trying to find what the details are. In this situation the ceding company is primarily liable to the policy holder; is that right?

A. Unless there was an assumption of risk, invariably that is true, yes.

Q. And as a result, the reinsurer is not primarily liable to the policy holder, is that right?

A. That is correct. He deals directly with the ceding company.

Q. The liability with regard to all the parties is the same as it is in this case, isn't it?

A. Quite similar, I believe. Let me think about that one moment. The relationships are the same.

[94] Q. Okay. The ceding company is primarily liable to the policy holder, the reinsurer is liable to the ceding company, under that theory?

A. Yes.

Q. And that's the extent of the liability. Okay. Under the surplus aid contracts, how does the surplus aid concept work? Why is it done, on the part of the ceding company?

A. Well, the ceding company, of course, would do it for their reasons, and now can I expand on this reason—on this connotation thing?

Q. I would rather not.

Mr. SINGER. Are we entitled at this point to know where Mr. Schwarz is going?

Mr. SCHWARZ. Yes, we are pursuing the problem of what unearned premium reserve means in the context where the premium is not received, although the insurance is in force. This is the effect under the treaties in this case.

Mr. SINGER. Where the premiums are not received?

Mr. SCHWARZ. The premiums have not been received, have not all been received for insurance which is in force, and I am pursuing the types of situations in which this has come up in the insurance industry in order to determine how the concept of unearned premium and unearned premium reserves takes this situation into account. We are talking about [95] surplus aid contracts, and under these contracts, as Mr. Eddy will testify, this kind of situation can come up, and I would like to explore just how it comes up and how this compares to the treaties in question.

Mr. SINGER. First of all, are we still talking about life insurance, reinsurance treaties, or——

Mr. SCHWARZ. Well, at the moment we are talking about any kind of surplus aid contract.

Mr. SINGER. How is it relevant to our treaties here? Are you saying that our treaties were surplus aid contracts?

Mr. SCHWARZ. I'm not trying to put a label on them.

Mr. SINGER. Well, then how——

Mr. SCHWARZ. I believe I answered the question. I explained that they are relevant.

Mr. SINGER. I don't see that he has explained, Your Honor. We haven't really—so far in this cross-examination I have yet to hear referred to at all to our treaties, or treaties of the same type. We are talking about life insurance, reinsurance treaties, which have nothing to do with this case, and we are talking about surplus aid treaties which, as far as I am aware, has nothing to do with this case, unless Mr. Schwarz says that our treaties are surplus

aid treaties, whatever they are. I don't see that he has established that this line of questioning is relevant here.

[96] The COMMISSIONER. Maybe we are getting a liberal education from the expert. Go ahead, Mr. Schwarz.

Mr. SCHWARZ. Thank you, Your Honor.

The WITNESS. Is it my turn?

By Mr. SCHWARZ:

Q. Yes. I will repeat my question, if you would like.

A. All right.

Q. Could you explain to us how, in a typical example, the notion of surplus aid can benefit a ceding company. If we take an example where a 100% of premiums are naturally received by the ceding company,—let's say the commissions in the example are 45%, a 2% retainage or commission is earned by the ceding company—or is paid to the reinsurer, excuse me, under the circumstances—so that the ceding company receives the premium, it will remit 55%—I will give you the outline and then you tell me how it works—remits 55% to the reinsurer, which is, of course, less the 45% commission, and the reinsurer assumes the premium.

Now, can you go on from there to explain how such an arrangement would work, where the liability runs and what effect this all has on reserves and surplus, the two companies?

A. Well, in your illustration we have too many things unanswered, unknown, rather, and for instance, if we are talking about life insurance, we would have a different [97] problem than if we are talking about accident and health.

Q. Let's talk about accident and health then.

A. And the surplus relief,—are we still trying to speak with respect to surplus relief, on a reinsurance premium?

Q. Yes.

A. Well, it's almost exactly the opposite of the type of treaties that we have here, but it in effect sets up—if we are talking about accident and health, it causes the reinsurer to establish a statutory liability in excess of the premiums transmitted to it by the ceding company, in the illustration which you have just given.

Q. The reinsurer, is that right? Is that what you are saying?

A. The reinsurer would establish a larger—they would establish a statutory reserve, assuming a hundred per cent

of the risk as being reinsured here—the reinsurer would establish the statutory reserve in accident and health insurance, as it's been said, as the gross premium. So in that case, in that event, the ceding company would have surplus relief, the reinsurer would have a surplus drain.

Q. Now, by surplus relief, could you explain what that means, as far as the ceding company's surplus is concerned and as far as its unearned premium reserve is concerned?

A. Well, I feel that I am repeating myself, but that's [98] all right if you want me to.

Q. That's all right.

A. The ceding company has decreased its assets, whatever they were—fifty-five cents, I believe you said—and it also, though, has decreased its liabilities for that policy, which are presumably in this illustration, was a dollar. Therefore,——

Q. By decreased the liability, you mean decreased unearned premium reserve?

A. Yes.

Q. I see.

A. I am afraid I used liability and unearned premium reserve interchangeably.

Q. That may be crucial here, so perhaps——

A. I will try to stick to the right terminology. The unearned premium reserve then is reduced by the dollar, and the net assets, maybe cash, was reduced by fifty-five cents. That's with respect to the ceding company.

Q. And the surplus increases by what?

A. Well, the difference, actually all this presumably works through an operating statement, so you have in effect a forty-five cent gain, and that is transmitted into an increase of surplus.

Q. Now, is the 55% less the 2% retainage figure, [99] isn't it arrived at in some view as to what the normal local experience would be on those policies?

A. Well, again this all depends on the type of reinsurance you are talking about. If you are talking about—well, the truth of the matter is, all reinsurers—all they collect or get from the ceding company, whatever it takes to pay the claims, so it is related to the insured risk.

Q. Okay. Now, if it turns out under these typical surplus aid contracts that the loss experience is adverse, that is, it

is worse than was contemplated by the party when it determined the portion of the premium which would go over to the reinsurer, isn't the insurer obligated to pay an additional amount to the reinsurer?

A. Not always. The practice varies——

Q. In some contracts isn't that the case?

A. In some contracts, that's true, yes.

Q. And isn't it true that if the loss experience is favorable in some of these contracts, the reinsurer will remit back to the ceding company a portion of that 55% it received?

A. Well, the surplus relief type of contracts that you are talking about, that's not the way it really w rks in practice.

Q. Isn't [100] that the effect, regardless of practice, isn't that the effect of what happens?

A. When the reinsurer substitutes for the issuing company, say in life insurance—and I am speaking of life insurance—but the same principles are involved, I believe, in all—once the reinsurer has recovered what it had to take out of its surplus at the outset, by making the substitution, with whatever rate of return it is satisfied with, through the terms of the agreement and through the mechanics of the agreement, then quite generally there is an automatic recapture by the ceding company.

So that after the one time when the reinsurer—he has provided surplus relief at the outset, he has waited until he's gotten—he's recovered, then the contract is terminated and the ceding company goes on its way and the reinsurer its way.

Q. The risk in this coverage remains with the ceding company, doesn't it?

A. The individual—well, to the extent that the premium income is adequate to meet the claims and fulfill the other terms of the agreement.

Q. That's the way it is in all insurance, isn't it?

A. Well,——

Q. You asume the risk whether the premium you have is adequate or not. The whole idea is if it is not adequate, [101] that's your risk.

A. Well, in the typical case of surplus relief reinsurance, typical case, you do not—the ceding company is really just a channel through which the premiums come in and the

claims go out and, of course, that offers administrative services during this period of time.

Q. And primary liability, does it not?

A. Well, not necessarily. What happens, unless the entire block of business goes bad, and quite generally the reinsurer is stuck with the loss, what happens in most typical surplus and relief contracts is that it is in effect sort of an open end arrangement, that this recapture doesn't occur until the policies continued in force have in fact made the reinsurer—reimbursed the reinsurer for its investment and cost, and an adequate return.

Q. Even though the insurer is assuming a risk on this insurance, it is still permitted to take credit for its own unearned premium reserve under the rules of some states, is it not?

A. If unearned premium reserved—the reinsurer would establish the unearned premium reserve in the illustration that you gave, because it received the premium, and the ceding company would take credit for it because it had received actually the transactions, would be in the ceding company's [102] statement—they would establish the unearned premium reserve because they had received the premium, but then because they had passed it on to the reinsurer, they would take an offset or credit and this would then net to zero on their balance sheet.

Q. And the effect is that they don't have, because of the credit, they don't have to show this unearned premium reserve liability. The only way—the effect of that is to increase surplus. Surplus couldn't be increased without the credit of the unearned premium reserve, isn't that right? It couldn't balance, could it?

A. No, of course, in the illustration we are talking about.——

Q. Did you say no?

A. Well, in the illustration we are talking about, I may have misstated the effect on the ceding company's balance sheet to this extent. You gave the illustration of a dollar premium and forty-five cents commission and fifty-five cents reinsurance premium. Without reinsurance, the ceding company would have had a net income of fifty-five cents, but would have established a liability of a dollar. If nothing else

happened, it would show a loss that year of forty-five cents. If nothing else happened, it would show a negative surplus of forty-five cents.

[103] Now, if it immediately reinsured with a surplus relief, or any other type of reinsurance, the whole risk at that point, by transferring to the reinsurer the remaining fifty-five cents which it had, and the full risk, the reinsurer then would be substituting for the ceding company. It would show on its books income of fifty-five cents, reserves of a dollar, and, therefore, a loss of forty-five cents, but the ceding company would be in a zero position.

Now, compared to not reinsuring, it would be forty-five cents better, but if we were just passing the money right through to the reinsurer, the ceding company would neither have a gain nor a loss as a result of the transaction.

Q. Now, in the example I just gave you, and I believe you agreed that there are ceding companies—there are situations like this where, if the loss ratio, that is, would be the 52%, which is the 55% less the 3% commission, if that 52% loss ratio was exceeded, that is, losses were greater than expected, the ceding company would be required to remit the losses in excess to the reinsurer and the arrangement were favorable, the reinsurer would remit the deficiency back to the ceding company. You have seen agreements like that. Are you familiar with that kind of arrangement?

A. Well, the explanations I keep trying to give, of my understanding of reinsurance and surplus relief reinsurance, [104] really isn't dealing with the questions that you are asking because you are asking things which to me strike or suggest that you are talking about single premium credit, A and H.

Q. I am not.

A. I am not talking in terms of that type of contract. I think that the type of contract we have here is pretty typical.

Q. Mr. Eddy, I am asking you about a typical A and H policy and a typical surplus aid contract as it might arise in an A and H policy. I am not talking about the contracts here, I am trying to get at a principle, and I would like to confine myself. Now, the example I am giving you is out of the same handbook, and opposing counsel can look at it

again if he likes, and I am told by this report, such a situation exists. I only am asking you whether in your experience you have run across this same situation.

Mr. SCHWARZ. Would you like to see this?

Mr. SINGER. Yes.

[Document referred to Mr. Singer.]

The COMMISSIONER. Off the record.

[Off-the-record discussion.]

The COMMISSIONER. All right, we will return at 2:00 o'clock.

Mr. SINGER. I wonder, if you would like to look at [105] this, or could he look at this before we resume cross-examination? Would that be helpful to you, Mr. Eddy?

The WITNESS. I think so.

Mr. SINGER. It appears that Mr. Schwarz is relying pretty heavily on this handbook and Mr. Eddy has not had a chance, at least recently—I don't know if he ever had a chance to read it—it might be helpful if he can read it over.

The COMMISSIONER. I am sure Mr. Schwarz wouldn't have any objection to his seeing it.

[Whereupon, at 12:45 p.m., the hearing was recessed, to reconvene at 2:00 p.m. the same day.]

[106] AFTERNOON SESSION

[2:00 p.m.]

The COMMISSIONER. You will resume the witness stand, Mr. Eddy. Proceed, Mr. Schwarz. Whereupon,

ARTHUR CROOKS EDDY resumed the stand and, having been previously duly sworn, was examined and testified further as follows:

CROSS-EXAMINATION (Continued)

By Mr. SCHWARZ:

Q. Mr. Eddy, before we return to the subject we were discussing before lunch, I would like to emphasize that some of the examples that I am giving to you are not exactly the same as the kind of treaty that we are involved with here. I am asking for purposes of comparison and in order to discuss the principle of an unearned premium reserve and the term "unearned premium," so you will have an opportunity to relate these examples to the treaty, either based on

questions that I ask you or based on questions in re-direct. So I would appreciate it if your answers are pointed and in direct response to my questions, and we will be concerned with the analogies later.

A. All right.

Q. Now, to return to the example we were discussing, have you had an opportunity to read the example that I referred [107] to?

A. The first paragraph, but I didn't get into the second one.

Q. Okay. Well, I can either go over it again or give you an opportunity to read it, whichever you would prefer.

Mr. SINGER. Whichever is easier for Mr. Eddy.

A. It's a little late. If you would just go ahead and ask the questions, I think I could answer you.

By Mr. SCHWARZ.

Q. The example,—I will briefly restate the example for the record. It involves a reinsurance treaty and the example does not state the type of insurance. It covers various types, but we can assume that accident and health insurance, and maybe even credit accident and health, I don't know, could be reinsured on this basis.

A. Would you be kind enough to read the italicized heading of the paragraph? I think that makes it quite clear.

Q. It's headed—the major heading is "Normal effect produced on unearned premium reserve and surplus of a ceding company by the session of reinsurance." It then discusses the normal effect which we discussed before, and then they go, under the next heading, to surplus aid contracts and then they define a surplus aid contract, and then they start with another heading called "Guaranteed profit contracts," and [108] the first sentence essentially says the most common form of surplus aid is the guaranteed profit contract.

So the one we are discussing in the example which we are going to pursue is an example of a guaranteed profit contract, which in turn is, as they say, I assume, a common form of surplus aid contract. Are you familiar with the term "Guaranteed profit contract"?

A. Well, to that extent, yes.

Q. Okay. And are the commissioners correct in saying that it is the most common form of surplus aid contract?

A. Well, I don't think I share that opinion.

Mr. SINGER. Excuse me, Your Honor. Is it clear that this is the commissioners saying this, or is this a report prepared for the commissioners?

Mr. SCHWARZ. Well, this section of the handbook is entitled, "Examiner's handbook, National Association of Insurance Commissioners." Now, we are in Part B, and Part B is entitled, "Reinsurance subcommittee reports as amended." Now, for the reference, they refer to the 1961 NAIC proceedings, Volume 1, pages 147 to 177, and that report is set forth here.

Mr. SINGER. Isn't there some introductory paragraph? This is a subcommittee of some committee of the National Association of Insurance Commissioners?

[109] Mr. SCHWARZ. It may be a subcommittee on reinsurance. I'm not introducing this into evidence.

Mr. SINGER. But you are speaking here as though the—what is contained in this handbook is something that the commissioners have said or promulgated. I don't think that that's correct.

Mr. SCHWARZ. Well,——

Mr. SINGER. A correct way of stating it.

Mr. SCHWARZ. All right. Let me be more specific. The subcommittee is called the subcommittee to study the question of reinsurance, and that is the name of the committee, and the introductory paragraph speaks of a meeting in 1950 of members of that committee, and this is the product of that committee—those committee meetings. This is a report.

Mr. SINGER. This is a report by the subcommittee based on meetings held in 1950.

Mr. SCHWARZ. That's right.

Mr. SINGER. And is there anything in there that shows that the commissioners have ever adopted these conclusions as their own?

Mr. SCHWARZ. Well,——

Mr. SINGER. Or are these just recommendations?

Mr. SCHWARZ. I don't know if any more can be said about that question, except that they have inserted that into [110] a handbook which they issued to examiners. Perhaps you could tell us what this handbook represents and what it is used for.

A. Well, it's somewhat of a guideline for examiners in performing their examination. In fact, that section, the parts that I read, dealt specifically with the treatment of reserves between reinsurance ceding company, and I think that's what it's for.

By Mr. SCHWARZ:

Q. Now, who are these examiners you are referring to?

A. Well, the several states have their own insurance departments which employ people classified as examiners, and these gentlemen, ladies and gentlemen, are supposedly familiar with the life insurance and general insurance, as well as life insurance, business, and they are required by their various states to examine the companies domiciled in the state in this triennial examination to ascertain whether their assets and liabilities are appropriate according to the state regulations and statutes.

Q. Who are these insurance commissioners who are members of the National Association of Insurance Commissioners?

A. Well, I don't know for sure that all commissioners are members of the association, but I suppose that they are. I believe that's true. The commissioners are in some cases appointed officers of the states. In some cases they are [111] elected officials of the state, and they have amongst their responsibilities and duties the supervision of the insurance affairs of the state.

Q. Do they also supervise the examiners who perform these audits you referred to?

A. The organizational structure varies between the states, but generally speaking, I am sure that the commissioners are considered to be their superiors.

Q. You said before, in response to direct examination, that an insurance company, say like a taxpayer who is domiciled in Missouri, would be subject to an examination by examiners not only from Missouri, but perhaps by other states.

A. If it were licensed in other states.

Q. I see. But it would be examined by examiners from all states in which they were licensed?

A. Well, not generally. The practice varies with this, too, and also it varies with the size and importance of the company to a given state where the company might be licensed.

But generally speaking, the states are divided into zones and the zone that the company is domiciled in encompassing more than one state, several states generally, will usually provide one or more examiners. Or excuse me—each state within its own normally would provide one or more examiners [112] to aid in the examination, and the chief examiner in an examination is most generally from the state that it is domiciled in.

Q. Now, what effect does this handbook have on these examiners in their work? First you said before that it was a guide to them?

A. Right.

Q. Their essential guide is the law of the state, is it not?

A. That's right, and regulations, and to the extent that this thing is not in conflict with the state laws or regulations that are involved in the particular examination, then this is the guideline and an attempt, as I mentioned earlier, for a uniform regulation of an insurance company.

Q. An example of a deviation between what may be suggested in the report and what the law is would arise, would it not, in a situation we discussed before, involving every insurer that is not licensed to do business? Are you familiar with the recommendation of the examiners, of the insurance commissioners, that the fact that a company is not licensed should not be taken into account; if it is a solvent company, the credit should be given regardless of the technicality of the licensing, but in fact some states still have licensing requirements?

[113] A. Oh, yes. In fact, the states vary considerably in their practice in that, and generally speaking, it's pretty much discretionary, I believe, for the state authorities, regulatory authorities, whether it be examiners or commissioners or whatever, to allow or disallow reinsurance credit for reserves, depending on their understanding of the solvency or the ability of the reinsurer. Some states—particularly New York, as an example—that's not quite true. You have to be licensed as a reinsurer in the state of New York, like in other states.

Q. You say they have some discretion as to whether to allow credit or not to allow under these circumstances?

A. That's my understanding, yes.

Q. Doesn't the state law originally and technically and specifically specify the exact circumstances under which the credit should be given or not?

A. Well, I don't believe so. Well, excuse me. I believe that the general evaluation laws do refer to reinsurance credit. In some cases, some states, I think, that you will find, though, that the reinsurance credit—first of all, generally speaking, you are permitted the reinsurance credit, but then I believe some state laws go beyond that and specify that they must be licensed.

Q. Are the individual commissioners within a state [114] given discretion on other questions involving the nature of reserves within the purview of the statute?

A. Well, as I said earlier, all states, I believe, have adopted the standard valuation law, which presents in concept or presents the philosophy of reserve valuation specifically with respect to many kinds of insurance. In other types it is very nebulous, but the law does—at least the standard provision does state that the calculation of other reserves should be consistent with the principles involved and the specifics that are given or enumerated.

There are other laws or other regulations that are involved, and if you ask me if commissioners have discretionary powers, it has been my experience in many areas where there is a lack of uniformity, sometimes with the regulations and sometimes the statutes are different with respect to the supervision of insurance companies.

Q. If the commissioners had required to reinsure the taxpayer in this case to create and show on its books an unearned premium reserve for the amount of premium it would receive under the treaty, would that be a violation of the state law as far as you know, as opposed to—in other words, would they have the power to do that if they felt that a reserve would be necessary, either to protect the ceding company or to protect policy holders, or for whatever reason? [115] A. Well, in my opinion, in the case involved here, I don't believe that they would have the power to impose that requirement on the ITT Hamilton.

Q. And the reason for that is because you understand the meaning of the reserve to be the amount of premium received, which has been unearned?

A. Well, there is no question in my mind that the unearned premium reserve, as determined in the life insurance industry, relates to the premium received and it is proportionate to the period of coverage. It doesn't have to do with dollars and cents, dollars received; it has to do with the portion of the period the premium covers, and sometimes it is related to gross permiums, it is sometimes related to the cost of carrying the insurance risk, sometimes it is statutory and sometimes in very rare cases you might find it related to the real cost of carrying insurance which would be less if you got to the mortality or morbidity tables.

Q. Now, the question which I started my cross-examination with and the one, as far as I am concerned, we are still pursuing, are situations in which a company has insurance in force but does not have the premium, does not hold, to use the plaintiff's term, the premium on that insurance, and in connection with that, we were discussing surplus aid contracts and specifically the guaranteed profit contract, which we left [116] off with a lunchtime. And let me review that example again briefly, and my question to you, with regard to that example, would be, first of all, whether you are familiar with it, and then to discuss it.

The example is one where the insurer, the ceding company, received a premium which we will describe in percentages as being 100%. It remits 55% of that premium to a reinsurer, 3% of which represents a payment to the reinsurer for its services in connection with this agreement, 45% of the total consists of a commission, which it, the ceding company, pays immediately to its agents, and under the treaty if the loss experience on this particular coverage is unfavorable, that is, the losses which the company has to pay exceed this 52%—now, of course, we are talking about an aggregate of all policies, not on any one policy—the ceding company would be required to remit the excess to the reinsurer because the reinsurer has been paying these claims all along, and if a loss experience is favorable, that is, it does not reach the 52% level, then the reinsurer will remit back to the ceding company a portion of the premium it has received. So the effect of the whole arrangements——

A. An experience credit of some sort.

Q. Yes. The effect of the whole arrangement is that the reinsurer makes 3% of the premium. That 3% is made without [117] any risk, it's guaranteed. That's all it makes, no matter what happens under the policy. If the claims experience is extraordinarily adverse, the ceding company suffers. If the experience is extraordinarily good, it benefits.

Now, are the commissioners correct in describing this as the most common form of—or is the report correct in describing this kind of contract as the most common form of guaranteed profit contract, or was it correct at the time?

A. It may be the most—as a matter of fact, of course, if we are referring to 1950, and if you say that this was something that was from the proceedings of 1950, I think that things may have changed since that time. I think perhaps maybe even during the period of this particular case, they may have changed. I think that that's a common form of contract in certain forms of insurance. I don't think by any means it is the most common form of surplus relief, reinsurance or co-insurance in the life insurance industry.

Q. Now, a surplus relief contract again is not the most common form of reinsurance, is it?

A. That is correct, it is not. It's quite common, but it is not the most common. The most common form is the regular risk premium reinsurance or yearly renewable term insurance, as it is sometimes called, or as we are talking about today, it is the ceded type of insurance. I think that [118] was the terminology. The terminology is the most difficult communication problem, but at any rate, I think that that is the common form of co-insurance. Now, I did see that illustration that you were talking about and I do want to point out—you said at no risk. Even the commissioners admit that there might be some remote risk here because if the claims aren't—they could exceed 100% of the premiums.

Q. How do they describe that risk? Do you recall?

A. Well, I said remote. I'm not sure that's the word they used.

Q. Largely of academic interest?

A. That's how they described their interest in it, but I think they refer to it as remote.

Q. I will read the sentence. "This is a remote possibility, largely of academic interest." All right. Now, let's review again the effect of this treaty on the surplus and reserves of the ceding company.

A. This is hypothetical? Well, this thing that you are referring to in the book?

Q. Yes.

A. Well, as I mentioned earlier, if this is the accident and health type contract where the reserve, the statutory—if the statutory requirement is the gross unearned premium, then the effect on the ceding company would have been [119] before reinsurance, one dollar premium, 45% expense for commission and after reserve requirement of a dollar, net loss of forty-five cents. After reinsurance, they would have a net zero premium income, net zero reserve requirement, forty-five cents—excuse me, I am not saying that properly.

They would have zero reserve, which is correct, and they would have—they would take their forty-five cents, or fifty-five cents of assets, and pay it to the reinsurer, and they would have then in effect no gain or loss on this transaction because they transferred a hundred per cent of their premium, namely, forty-five cents to the agent and fifty-five cents to the reinsurer, and a hundred per cent of their liability, so they got no gain or loss after the transaction.

Q. What's the effect on the surplus?

A. Well, related to their surplus before the transaction commenced, it is no effect.

Q. Right.

A. But related to their surplus if they had reinsurance or not, but the transaction did exist, then they have increased their surplus by forty-five cents.

Q. At the moment it receives the premium, if at that time a statement were made, the effect would have been that they would have to create a reserve of one for one, as you say?

A. Yes.

[120] Q. It would have an expense against that of——

A. Forty-five cents.

Q. Forty-five?

A. Yes.

Q. And those—most of those items would be going against surplus, wouldn't they, whereas it would be only one forty-five against surplus, but only one of income. Wouldn't that be a loss? Wouldn't that loss reduce their surplus?

A. That's true.

Q. So the effect of it is that when the reinsurance takes place, if you can say, the effect is to increase surplus over the situation that I just described?

A. Correct. Before the transaction—excuse me. Without reinsurance, and we do have a transaction of the insurance sale, there is a surplus drain of forty-five cents or a loss, which reduces the surplus forty-five cents. If the transaction continues through a reinsurance arrangement, then the effect on the company is zero, or compared to no reinsurance, it's a 45% improvement of surplus, or forty-five cent gain.

Q. So it is a restoration?

A. Yes, it really puts them back in a position as if they hadn't made the transaction.

Q. Now, an effect of this whole thing on the reinsurer, and we did cover this somewhat before, but now that we have the [121] example straight, I appreciate your opinion. What is the effect on the reinsurer?

A. If again we are speaking of A and H insurance, so that we can say that the statutory reserves related to the gross and not to the net——

Q. Okay, let's assume that.

A. All right. We have to make that an assumption, otherwise my illustration would be incorrect.

Q. All right.

A. In this event, the reinsurer would receive fifty-five cents and it would establish a reserve of a dollar, thus showing a loss of forty-five cents or a reduction in its surplus of forty-five cents.

Q. Okay.

A. I don't know if it is appropriate or not, but I would like to point out one thing, and I think that the commissioners refer to this, too. The theoretical surplus or imaginary surplus—in the first place, the requirement for statutory reserves of a dollar is somewhat unrealistic.

Q. We will get to the significance of the gross versus the net. I believe that is what you are alluding to.

A. No, not really. I just wanted to mention one thing. The accounting profession of——

Q. I will have to ask you to—if you are—if on [122] redirect they want to go into that, they will have to do it. It's not really appropriate here.

A. Okay.

Q. Now, except for this remote possibility of losses exceeding total premium that you referred to when we discussed it before, who has the risk of loss?

A. Barring that risk, then you have to assume that the ceding company has the risk.

Q. The ceding company?

A. Yes.

Q. Not only assume it, it does have the risk, doesn't it?

A. Barring that possibility, yes.

Q. Okay. Now, under those circumstances, some states, and I don't know how many, perhaps I could ask you, would allow—did allow a credit to the insurer, to the ceding company, for the unearned premium reserve on those policies?

A. Correct.

Q. And it allowed the reinsurer to establish that reserve?

A. Correct.

Q. Now, before you said several things about the nature of the reserve. First of all, you said that the reserve was designed to provide a fund from which a refund could be made [123] to a policy holder in the event that the policy was canceled.

A. I said that was the rationale for establishing gross unearned premiums.

Q. Okay.

A. I don't admit to the reasonableness of the requirement.

Q. Okay, just the rationale, pardon me. Now, the reinsurer has the premium here, doesn't he? The forty-five cents has gone to the commissioner—the agent——

Mr. SCHWARZ. Pardon me, Commissioner.

By Mr. SCHWARZ:

Q. And the remainder has gone to the reinsurer; is that right?

A. Yes.

Q. All right. Now, if the policy holder asks for a refund, there is only one place he can turn for the refund, isn't there, under his policy?

A. To the ceding company.

Q. Okay. Now, where are they going to get the money?

A. They have to turn to the reinsuring company.

Q. Okay. And if they don't, if the reinsuring company has become insolvent in the meantime, what do they have to do?

A. Well, I presume they have to take it out of their own accounts.

[124] Q. Their own accounts?

A. Yes.

Q. Okay. Now, the commissioners have said about this kind of arrangement, I am quoting from the report, and if you would like to look at it, you can, but I believe there is an accurate quote—it says, "It appears that some uniform law against credit for transactions of this type is necessary unless the general plan for the regulation of insurers is to become meaningless to a great extent."

Now, first could you, before I ask whether you agree—I am curious to know what your understanding of their concern is, what do they mean by the general plan for the regulation of reinsurers and why might that become meaningless to a great extent?

A. Now, I can say what I wanted to say earlier. This all evolved, I think, because as I started to say, shortly after the Second World War there was a great outgrowth in small new insurance companies, and if they were successful in selling business,—take the accident and health—this is a pretty good example, where if they have to pay forty-five cents out in commissions, and even though the fifty-five cents left over is completely adequate to pay claims, they were forced to establish a dollar reserve, it doesn't take many such sales for a small company, related to the size of the [125] company, before it is statutorily insolvent, and this is because of the requirement of the gross unearned premium reserve, a statutory reserve.

Therefore, many of these companies came into existence and found ways to continue in existence through surplus relief reinsurance, and amongst them being the type—certain types of policies, particularly short term casualty type

policies, the type that you are talking about here as guaranteed profit reinsurance arrangements.

Now, the commissioners—another aspect of this thing—many of these companies had poor reputations because some of their policies were specialty policies. Many of the sales were made supposedly, reportedly, by misleading the customers, and the insurance industry and the commissioners were concerned about the continuing existence of them, which they could control if they were requiring a certain statutory solvency, which they couldn't control as long as they remained statutorily solvent through this surplus relief.

I believe, myself, that that is the source of this type of concern and the cause for it, and, although, I don't believe today that there is any way that they can deny this credit. In fact, I believe that in this stuff that you have just read, they say in effect that there is nothing they can do about it.

[126] Q. Do you think that the general plan for the regulation of insurers, that they refer to, contemplated—took into account this kind of an arrangement? This kind of arrangement evolved when, did you say? After World War Two?

A. Well, the surplus relief co-insurance has been in existence probably most of the century, but I can't say for sure when it came into effect, but I know for a fact that these small new companies were mostly created since World War Two. That's when we had the great increase in the number of companies.

Q. Now, the suggestion they seem to be making,—tell me if I understand this—is that a bar against credit should be required in transactions of this sort.

A. Sure, if they could disallow credit, these companies would become insolvent statutorily.

Q. Have any states taken that advice?

A. I don't know. My own opinion is they couldn't.

Q. They could not?

A. They could not. That's my opinion, but I don't see how they can do that. I don't know for a fact whether any state has or has not.

Q. Do you know if any states previous to this suggestion had prohibited such a practice?

A. Again I say I don't think that they can.

[127] Q. I am asking you, do you know whether they have?

A. No, I don't know of any examples where they have.

Q. Okay.

A. I know of a number of cases where there has been pressure to do it, but they never have succeeded in the cases I have been involved with.

Q. But in a case where the states have in fact prohibited it, if such a case exists, and you said you don't know, is that right?

A. Yes.

Q. Or in a case where under the existing law the commissioner exercised discretionary authority and prohibited that, the effect would be to have two unearned premium reserves, wouldn't it—one on the part of the insured and one on the part of the reinsurer?

A. If we could have the hypothetical situation where the ceding company was barred to credit but the accepting company had the money, then yes, you could have.

Q. I would like to read you another quote from this handbook and ask whether you agree with it or disagree. "Although it is a fully recognized fact that the procedure in the United States with respect to setting up an unearned premium reserve equal to 100% of such unearned premiums without credit for acquisition costs, sometimes results in [128] the establishment of hidden reserves in the guise of unearned premium reserves"—the trouble with some of this is the sentences aren't appropriate—that's not a sentence, but there is a period.

A. I follow that perfectly.

Q. So I will continue. "There are arguments in favor of this practice. The heavy charge to surplus for such acquisition costs sometimes prevents the ambitious or over-rapid expansion of a company that might well result in its ultimate insolvency. It further imposes in an indirect manner additional capital requirements on companies having large amounts of business in force." Do you agree that it does serve that function?

A. I do agree that that's a result of it.

Q. And the uniform practice in all states on accident and health and credit accident and health insurance is the gross unearned premium?

A. Yes, for the direct insurer.

Q. And for the reinsurer, too?

A. Well, it depends on what we are talking about.

Q. Let's take an example.

A. Today I'd say yes.

Q. What?

A. Today that answer is correct, yes. There is no [129] question about it. As a matter of fact, subsequent to the publishment of that book, the NAIC changed its convention blank and instructions to tell a company how to complete the convention blank. By convention blank I am referring to the annual statement. They include specifically a question relating to reinsurance of accident and health insurance, and the companies are obligated to answer that they do or do not show—the reinsuring companies are obligated to answer yes or no that they have included the gross premium charged by the ceding company as their unearned or not.

Now, just to answer that question doesn't mean that some companies don't continue to do it or some states don't continue to permit it, but it is, and very much, I suspect, as a result of this, these recommendations now, one of the questions that are in the convention blank. I didn't think of that this morning or I would have mentioned it at that time, but I did know that during this period of time that we were talking about, that the practice was for the reinsurer to set up a net reserve rather than a gross reserve, and it was right about that time or the end of this period that some of the states began to require that the reinsurer establish gross reserves and not net reserves.

Q. And they did that after the commissioners changed the blank and reported their——

[130] A. Well, no, I think some states probably impose this as a requirement through regulation, before the commissioners actually changed the convention blank.

Q. I see. So the authority existed under state law and they promulgated the regulation or changed the practice of the administrative proceeding?

A. In some states, and not in some. I just happen to have had experience with one or more states on this.

Q. I see. Now, I am curious to know why, before this practice was challenged, why the commissioners in the insuring state would permit the company to take a credit for reserves even though the insurer was still primarily liable on the policy when the purpose of the reserve, as you stated

before, one of the major purposes at least is to provide a fund for the payment of premiums over the remaining term, which the company is bound under the policies. Is there any rationale?

A. Excuse me—payment of claims.

Q. I am sorry.

A. You said premiums. Excuse me, what was the question?

Q. I am curious to know why some of the commissioners in these states would have permitted insurers to take a credit for reserves under these circumstances where they retain the risk. Might one of the reasons be that it wasn't like the insured was out in the cold, there was a reinsurer and the [131] reinsurer had a reserve, and even though the policy holder couldn't go against the reinsurer, the insurer company, and so there was a reserve—there was one reserve at least held by an insurance company with respect to this obligation. Might that have influenced their decision to allow the credit before it came into criticism?

A. Well, I think they allowed a credit before and after any criticism, but the point is that the reserve, however it's defined in the statute, is related to the premiums that have been paid. This is on a retrospective basis, as I have said—you've got to have remaining or left over enough to cover the unexpired period of coverage. Now, it doesn't relate to the gross premium as charged to the customer except in the case of accident or sickness, and that just happens to be the way that the regulations require, or the statute requirement for reserve. It might relate to a net cost of carrying the risk premium and not the gross premium.

Q. The gross premium isn't just limited to accident and health insurance, is it?

A. Well, most fire and casualty coverages,—most casualty coverages, the gross premium is the basis for statutory reserves.

Q. For tax purposes, too?

A. Well, yes.

[132] Q. Is that true for A and H as well?

A. Yes.

Q. And credit A and H?

A. Yes. I am not recommending that you change it, but that's the case.

Q. The companies prefer it on a gross basis?

A. I can't answer that. I would suspect yes.

Q. Why do they prefer it on a gross basis?

A. Well, the answer has got to be obvious. From a tax deduction point of view, it's a larger deduction.

Q. From your understanding, do you know what the deduction was of the insurers under our treaties? Was it gross or net?

A. Well, I don't know for a fact. I just know it from my understanding of the terms of the agreement and what I think that they actually did in practice. They were taking gross—as a matter of fact, I can say for sure about Pilot because I was there—we were taking the reserve, we had it set up for statutory purposes, which was the gross.

Q. Okay. Now, we have through all this time—we have covered two examples of the kind of situation which I asked about when I opened my cross-examination. To refresh me and everyone, I will repeat it. I was asking for examples in your experience of situations where a company had not received a [133] premium, did not have the premium, but had insurance in force with regard to that premium, and you gave me—the first example was the situation where policies providing for annual premiums, remitted to the ceding company, would be reinsured on a monthly premium basis. That was your first example. The second example was one that I introduced and discussed at some length, the surplus aid contract and the guaranteed profit type of surplus aid contract. Can you think of any other examples?

A. Mr. Schwarz, I didn't mean to say, if that's what you just said I said, that I think that insurance exists in force as a general rule and as a practical matter without the receipt of premiums. I did mention that there is a timing question and there is a period of time, maybe the grace period, namely the grace period, in an ordinary policy, and also a timing question with respect to new insurance of almost any kind where the premium maybe hasn't been paid and the insurance company is treating the insurance in force, but if it came to a claim payment, one wouldn't be made, excepting under certain exceptions.

Q. I believe, and I apologize for not including that in my review, in connection with the first example. You did say that under some policies, although the premium was required to be paid at the beginning of coverage, under the policy,

[134] the practice was that sometimes there was a delay and sometimes the policy provided for a short grace period within which the policy would be paid.

A. The grace period is in the renewal area, it's not at the outset. But at the outset you have the practical problem of getting the premium precisely at the moment that the coverage is approved and put into effect, but I don't believe there are any cases where the insurance would be honored as being in force if the claim should be incurred before the receipt of premium. But there are exceptions to that, which I can think of, but it's not the general thing.

Q. All right. Well now, again, you have covered two examples and I am asking for others, any others that you have had in your experience, which conform, and I would like to discuss those with you, if you can name them.

A. You asked me for examples in my experience where insurance was in force without the premium received? Well, I don't intend to have given you any of them, so far. I just don't think that in the payment of claims you wouldn't make claim payments on premiums when you haven't received premiums.

Q. You can have insurance in force without paying a claim, can't you? I have a homeowner's policy and I haven't had a claim yet, but the insurance is in force yet.

A. You paid the premium, haven't you?

[135] Q. Sure have.

A. Okay.

Q. So can you give me examples of the sort that I asked? It seems to me the first two you have given are examples, and we have discussed those examples.

A. Well, no, I still disagree that that's an example of your question.

Q. Well, don't argue with my characterization. I just want factual situations which conform to that mode. Now, I asked you the first example involved a life insurance agreement and you told me, well, the policy requires the premium to be paid at the outset but sometimes it isn't. Okay, we will accept that. And under the reinsurance of those policies providing for annual payments, a reinsurer may pay on a monthly basis, and that monthly reinsurance premium may come a little late or may come within a grace period.

A. Again, a timing period.

Q. All right, we will accept that.

A. But in a settlement, any final settlement, the benfit will also relate to the period for which the premium had been received.

Q. I understand that.

A. Okay.

Q. Now, in both of those examples, policies required [136] by their terms the premium to be paid at the outset?

A. Yes.

Q. All right. Now give me some examples where they don't, where the policy, or the treaty or whatever, where it doesn't require it to be paid at the outset but coverage is in force for the period for which the premium is eventually going to be paid.

A. Well, if the question is an example of a case where insurance might commence before the premium is due, whether it is paid or not,——

Q. Excuse me, you will have to repeat that. I didn't follow you.

A. I say, if you are asking for an example where insurance might commence, the effect would be to make the insurance company liable for a claim prior to the date that a premium is due, I don't believe there are any. If you are saying before the actual receipt of the money, I think there are the cases that I have said and they are purely timing problems.

Q. Well now, under the reinsurance treaties involved in this case, the insurer, reinsured,—and I am referring now to the Pilot and National Fidelity treaties, and you can assume I am referring to those unless I refer to the Old Republic treaty—the Pilot and National Fidelity treaties [137] were identical in their provisions, were they not?

A. Fairly nearly identical, yes, if not identical.

Q. Under those treaties the insurer was required to, and the reinsurer was required to accept, to reinsure 100% of the liability which the insurers had accepted with respect to credit accident and health policies issued to the debtors of Aetna Finance Company; is that right?

A. Yes.

Q. So when a debtor of Aetna Finance took out a loan, and I understand the average loan for which this kind of coverage was provided was a two year loan, and let's assume

two year policies throughout, the provisions were that the insurer would reinsure 100% of its liability with the reinsurer,—is that your understanding?

A. Yes.

Q. The reinsurer's liability commenced the moment the insurer's liability commenced and would not terminate until the insurer's liability terminated; is that your understanding?

A. That is my understanding.

Q. So at no time was one liable without the other one being liable?

A. Right.

Q. In these cases the primary liability was with the insurer?

[138] A. You mean the liability to the policy holder?

Q. Yes.

A. Yes.

Q. And the insurer would then have the right to turn to the reinsurer for any claims it had to pay out?

A. The ceding company would, yes.

Q. The ceding company, I'm sorry.

A. Yes.

Q. Okay. Now, is it your understanding that when such a treaty—when such policies were accepted by the ceding company under this automatic reinsurance treaty, that the reinsurer accepted liability to provide coverage for the full term, two years in our example?

A. Sure.

Q. Is there anything in the treaty that suggests otherwise?

A. Not as long as the ceding company made their premium payments.

Q. Does it say that in the policy?

A. Well, I'm not sure. I'm not sure it says that, but——

Q. You have examined these?

A. Yes, I have examined them.

Q. Would you like an opportunity to look at them again?

[139] A. Well, I'm not sure it will help. Can I ask you a question?

Q. No, I asked you whether there is any provision in these policies which said that the liability of the reinsured terminated if it did not receive a monthly premium?

A. The termination provision relates to the termination of the coverage of insurance.

Q. What does that say?

A. Well, I couldn't quote you verbatim, but the liability of the reinsuring company is coterminous with that of the ceding company.

Q. And what do you take that coterminous to be?

A. It ends at the same time.

Q. It begins at the same time?

A. In other words, you mean it begins at the same time, but I think it runs for the same period.

Q. That seems to be contrary to your suggestion that the insurance would terminate if the premium wasn't paid.

A. Well, I don't know that it does, and I really can't answer that. I think that the reinsurer would not pay any claims if it hadn't received the premiums. As a matter of fact, one of the provisions of the treaties call for claims to be deducted from the premium payments.

Q. But you don't see any term in the treaty which would [140] suggest that, do you?

A. Suggest what I just said? There is a term in the treaty that says that claims will be deducted from——

Q. Yes, not that. There is no term in the treaty which says if the insurer fails to remit the monthly reinsurance premium as provided under the policy, the policy will terminate and the reinsurer will be no longer liable for any coverage provided under the policy. Does it say anything like that?

A. I don't believe so, but I believe I would have to read the contract through to be sure, but I don't think it does.

Q. Is there a grace period in these treaties whereby the insurer has a delayed period within which it might pay?

A. Not in these treaties, although I'm not sure about the premium payment clause. As a matter of fact, there is a premium payment clause in it that they were to remit by the 25th of the month, I believe, following the month of coverage, so there is that much. It's not a grace period, but it is a delay in making payment, and that provision is in there.

Q. Yes, but that is the due date. There is a specified due date but no statement about what would happen if it wasn't paid on that due date.

A. No, I don't believe so.

[141] Q. Now, on a typical A and H policy, a typical life policy, there is a grace period, isn't there?

A. There is a great difference between the policy—the contract between the insurance company and the insured as compared to a contract between two insurers.

Q. The example we discussed in our first example, if the monthly premium wasn't paid by the insurer to the reinsurer, the policy would cancel, it would automatically terminate, wouldn't it?

A. No, I think those treaties are very much like these in that regard.

Q. First of all, the premium payment on those treaties you said was payable at the outset of the coverage for the month, by the reinsurer as of January 1st under the example which you gave. I would pay one month's premium and in February I would pay another month, then I would have a grace period, and if I failed to pay, the policy would—the reinsurance treaty would lapse and I would have the risk myself.

A. Well, again——

Q. Is that what you said?

A. No, I did not say that. I said that the reinsurance agreements, the type that I am talking about, where there is a requirement for a monthly remittance of premiums to the [142] reinsurer from the ceding company, is quite similar to this. I'm sure they've got cancellation provisions, but they don't specifically say it cancels if you don't pay the premium. It does say that the reinsuring company is on the risk as long as the ceding company—to the extent that the policy is reinsured, of course—and if the ceding company gets off the risk, the reinsurer is off the risk. I really can't recall off-hand the conditions under which a reinsurer cancels the contract for non-payment of premiums. I don't believe I have ever seen that provision in the insurance contract, as a matter of fact.

Q. So you don't know—what you are telling me is you don't know what the provisions are, you don't know when the premium is due under a reinsurance?

A. I know when the premium is due, I am not saying that. I am saying I don't think these reinsurance contracts or any reinsurance contracts generally, that I have seen, have any

specific cancellation for non-payment of premium. They have other provisions, which I believe will in effect protect the companies, but——

Q. Such as what?

Mr. SINGER. Excuse me, Your Honor. We have been allowing this line of questioning to go on even though the treaties are in evidence, as I am sure Mr. Schwarz would point [143] out and has pointed out in our past submissions, that they are the best evidence of their terms. But I think perhaps, so that this interchange will make some sense, there is a paragraph in the Pilot and National Fidelity treaties which we think is relevant and perhaps should be read. Maybe Mr. Eddy, having been reminded of this paragraph, might have a better basis of answering Mr. Schwarz's questions.

Mr. SCHWARZ. Certainly.

Mr. SINGER. This is paragraph 5 of——

Mr. SCHWARZ. One moment. I will get my copy.

Mr. SINGER. Paragraph 5 of the Pilot Life Treaty, and also paragraph 5 of the National Fidelity Treaty. "If this agreement is terminated as to new insurance, Pilot Life shall nevertheless be liable to American Universal for payment of monthly reinsurance premiums until all premiums on policies reinsured with American Universal prior to the termination have been earned."

Mr. SCHWARZ. Excuse me. Would you point that out to me again.

Mr. SINGER. I'm sorry, Roger.

Mr. SCHWARZ. Paragraph 5 here?

Mr. SINGER. Yes, this is it, under Article 3.

Mr. SCHWARZ. Would you repeat it again.

Mr. SINGER. Do you want me to start from the [144] beginning?

Mr. SCHWARZ. Please.

Mr. SINGER. Okay. I am sorry, I should have made that clear. This is Article, Roman, III, paragraph 5. "If this agreement is terminated as to new insurance, Pilot Life shall nevertheless be liable to American Universal for payment of monthly reinsurance premiums until all premiums on policies reinsured with American Universal prior to the termination have been earned, and American Universal shall

nevertheless be liable to Pilot Life for payment of all claims arising out of policies reinsured with American Universal prior to the termination. After all reinsurance premiums have been paid, American Universal shall pay Pilot Life the amount of any claims on such reinsured policies, which claims were paid by Pilot Life and not deducted from reinsurance premiums, upon receipt of a statement of the amount of any such claims."

A. I understood your question to be, and I interpreted it to be the type of provision that is in the policies directly with the insured, not in the case of a credit accident, because he pays a single premium, not in case of these contracts, because they are single premiums and there are no future premiums from the policy holders, but I was trying to interpret your question in light of the non-payment of premium provision that you find in the normal life insurance policy, [145] which specifically says if you don't pay the premium, the policy lapses, but that type of provision is not in these contracts. That's the way I was trying to answer your question.

By Mr. SCHWARZ:

Q. Is the provision of the sort that we described here, the sort that Mr. Singer just read—in other credit reinsurance treaties, credit accident and health, credit life reinsurance treaties?

A. Those, but they are runoff provisions, so-called runoff provisions, and those on a monthly premium basis, sure.

Q. They require the reinsured to provide coverage for the remainder of the term and they also require the insurer, the ceding company, to remit full premiums with regard to policies in force when they are due, even if coverage is canceled with regard to new insurance?

A. Correct.

Q. Now, what other kinds of insurance, other than credit reinsurance, other kinds of reinsurance, other than credit reinsurance, have you seen that particular provision in?

A. Well, that provision would be in all contracts of reinsurance. I mean you can find all types of arrangements. I'm not presuming that in every case that you have this, but generally speaking, in reinsurance contracts, either company can cancel the contracts, usually within sixty or ninety days

[146] notice, with respect to new business, or sales not yet made, but not with respect to business in force, and in any type of policy, reinsurance contract, where there was coverage beyond the cancellation date, with respect to policies then in force, from which the reinsurer had not received all the premiums, it was yet due, the agreement would provide for continuation of premium payments by the ceding company to the reinsurer and a provision, the same provision, I suppose, requiring the reinsurer to continue to carry—to provide the protection until the expiration of those policies.

Q. You have referred to policies other than credit reinsurance. Can you give me such policies that you have seen?

A. Practically every insurance agreement I have ever seen, I don't know how many of those are, but there are a whole bunch of them.

Q. What are the cancellation provisions you referred to before? They didn't relate—you didn't say they related to the coverage that still was yet to come, but to future——

A. Policies that would be issued beyond, after the date of cancellation.

Q. You also suggested that there were some provisions analogous to the provision of permitting the policy to lapse in the event that the insurer did not remit the next month's [147] reinsurance premium.

A. No, I didn't say that. In fact, I said that that wasn't in there. The provision in the policy—the contract between the ceding company and the insured has such a provision. In fact, it's a premium payment. It's a cancellation in the event of non-premium payment and it's a standard provision as part of the requirements of all states to be in all individual insurance policies that are paid on the basis other than single premium.

Q. You mean an insurer is required, if he has a monthly reinsurance treaty, a typical monthly treaty requires him not to insure monthly but to insure for the full term the insurance.

A. No, I was talking about the contract between the insuring company and the policy holder. There is a provision, a standard provision requiring the insurance company, incorporated in the policy, a provision which in effect says the policy cancels on non-payment of premium. Now, that

provision is not in these reinsurance contracts or in any reinsurance contracts, but there is a provision somewhat similar to the one that was just read to me in all contracts that I have ever seen on reinsurance unless it does not provide for the runoff. If it doesn't provide for the runoff, then the cancellation could be complete with respect to all [148] policies at the moment of cancellation.

Q. Doesn't the typical reinsurance treaty give the party the right to cancel on thirty or sixty or ninety days notice?

A. I think it gives both partie the right to cancel.

Q. How much notice is generally required?

A. It varies—sixty to ninety days. I think not less than sixty, not generally more than ninety.

Q. Are you telling me the typical reinsurance treaty requires—permits either party to cancel in sixty to ninety days notice?

A. Generally speaking.

Q. Or some such. Does this treaty have any term of that sort in it?

A. This has a termination provision in it, yes.

Q. But you said that the entire—can the entire coverage, even coverage in force, be canceled?

A. Well, these three treaties are different.

Q. I am talking about these. I am comparing these two, the Pilot and National Fidelity, to other reinsurance treaties.

A. But those two treaties provide for termination, but the coverage is only with respect to business issued after the moment of cancellation.

Q. Now, does the typical——

[149] A. That's the same with these other treaties.

Q. My understanding was that the typical reinsurance treaty provided that the insured—I'm sorry, provided that the ceding company could cancel future reinsurance on all business which it was then insuring by giving the reinsurer notice. It would not have to pay future reinsurance premiums. In other words, a ceding company wants to reinsure a certain amount of its business, knows that when it gets to a certain point, it will be able to handle that business on its own or it may want to reinsure with someone else, and the typical reinsurance treaty provides for a monthly reinsurance premium for all business in force.

So if there is a million dollars in force, the premium would be a percentage of that or a rate per thousand, and provide for monthly reinsurance premiums. That payment would be made at the beginning of each month for coverage for the month that was beginning, and the insurer, the ceding company, would have the right to cancel the entire treaty and either insure with someone else or take the business itself.

A. Only with respect to policies that had not yet been sold, not with respect to policies then in force. But there are exceptions and those are the cases where you do not have a runoff provision. If you don't have a runoff provision, and there are treaties like this, where companies are willing to [150] cancel either way, sometimes unilaterally, sometimes bilaterally on a given notice, or generally sixty to ninety days, sometimes less than that, but——

Q. Can you give me—can you state a treaty that you have seen, other than a credit accident and health reinsurance treaty which permits—which requires that the insurer continue to reinsure with respect to coverage in force on this monthly basis?

A. Well, yes, you can examine the reinsurance treaties of Lincoln National with any number of companies. I will mention one that specifically I knew, several—one is with the Pilot, one is with Jefferson, one is with the State Capital.

Q. What kind of insurance is this?

A. Beg pardon?

Q. What kind of insurance coverage is this?

A. This is what we have been referring to as ceded—do you call it ceded reinsurance?

Q. What kind of insurance policies are being reinsured?

A. Different types. In some cases accident and sickness, sometimes life, mostly with the Lincoln treaties—mostly they are in the life insurance business, although they offer reinsurance. The American United—very heavy on accident and health reinsurance. You can look at treaties on [151] those, they are quite similar.

Q. And they do not permit the insurer to cancel the reinsurance——

A. No, there is an exception in that, which I have mentioned, that there is generally today, particularly in new treaties, and I suppose most treaties have been amended, in particular where

the client was big enough to insist on it, due to competitive influences. There is the provision for recapture, or not generally, immediately, but there is some period of time that the reinsurance company has to protect it, usually three to five years. In earlier days, fifteen, twenty years ago, you didn't have such provisions in the treaties. Once reinsurance commmenced, it was in force until the end of the policy, regardless which party wanted to cancel.

Q. In the kinds of policies you are referring to, it would be where the premium paid by the ceding company to the reinsurer would, say, be on a monthly basis, whereas the premium it was receiving would be on an annual basis, or some longer basis?

A. You had all combinations. You would have the case where the policy holder was paying monthly and the ceding company is paying to the reinsurer annually. They had the cases where the policy holder paid single premiums and the ceding company paid to the reinsurer annually. You also have [152] cases with any sort of premium between the policy holder and ceding company, monthly payments, annual payments. I don't know of any cases where the ceding company pays a single premium where the policy holder pays annually. I don't know. But practically any kind of policy is in existence in both directions.

Q. I'd like to continue with the treaties in force and dicuss a couple terms.

Mr. SCHWARZ. Can we take a five-minute recess, Your Honor?

The COMMISSIONER. Very well.

[After a recess, the hearing proceeded.]

By Mr. SCHWARZ:

Q. Let's turn to the Pilot and National Fidelity treaties. Do you have a copy of one of them there?

A. I have the National Fidelity.

Q. The A and H treaty?

A. Yes.

Q. Is it your understanding that under these—I'd like to review some of the terms of the treaty, and I realize, as Counsel said, they speak for themselves, but I'd like to get the workings of the treaty in perspective.

Each month the earned premium portion of the premiums received by the insurer would be calculated, and is [153] it cor-

rect that they were done by taking the premiums received during the month and adding the unearned premium reserve at the end of the previous month, subtracting the unearned premium reserve at the end of the month, and that would be the basis——

Mr. SINGER. Mr. Eddy was not an actuary of our company during those years, and I don't think he can tell you——

Mr. SCHWARZ. All I am trying to is identify the term.

Mr. SINGER. He can testify whether that is the term of the treaty, sure.

Mr. SCHWARZ. That's what I am asking.

A. Yes.

By Mr. SCHWARZ:

Q. I want to make sure I understand it. Now, there was a 2% retainage, and I understand 2% would be taken off that figure.

A. That's my understanding.

Q. All right. Now, under Article III, item 3, it says—paragraph 3—it says, "From the reinsurance premium due American Universal, it shall be deducted and withheld by Pilot Life," and then (a), following Expenses, which were assumed by American Universal: "One, premium taxes; two, cost of the forms; three, special claim expense; and four, commissions, paid or retained by agents for writing the insurance."

[154] Now, is it your understanding that, or do you know, whether full commission or only—full commission paid by the insurer in this business or only part of it would be subtracted from this monthly premium that is to be remitted?

A. Well, according to these terms, it was commissions paid. That would be—to me that means whatever the total commission paid was during the month.

Q. So in the early——

A. Cash payments.

Q. Is it correct then in the early months of such a treaty, the commission paid on these policies by the ceding company would be much more than monthly earned portion of these premiums?

A. Well, that depends on the basis of commission payment. I don't know how to answer that without having examined their accounting.

Q. All right. If the commission payment were between 20 and 30%, if it were between 20 and 30% of it——

A. Of what?

Q. Of the premium—that the ceding company received from the policy holder,——

A. All right, this is 20 or 30% of the cash premiums received from the policy holders?

Q. That's right.

[155] A. All right.

Q. And these policies averaged—let's assume they averaged two years in length, and I believe we stipulated what the average was.

Mr. SINGER. No, we didn't, Roger.

Mr. SCHWARZ. All right. Then let's just assume that for the purposes of the hypothetical question—would not the commission payable in the early months of this treaty be far in excess of the earned premium portion that was to be remitted to the reinsurer, even before claims were deducted?

A. You mean like the first month this treaty was in effect, as an example of early months?

Q. Yes, let's take an example.

A. The treaty went into effect July 1, 1957, and you mean for the month of July, 1957, would the commissions paid be greater than the earned premium? In all probability, yes. I am assuming that they are paying 20% cash on the gross premiums. That's what I suspect they did.

Q. Now, is this a typical reinsurance treaty provision whereby in the early months of a treaty, the reinsurer would have to make substantial payments to the insurer, even before any claims during that period were deducted?

A. The reinsurer paid substantial payment to whom?

Q. To the insurer.

[156] A. The reinsurer doesn't make any payments to the insured.

Q. It says, under Article IV, "For the time established remaining, any premium remittance, the total of the deductions listed in the preceding section of this article exceeded 98% of the earned premium for the month, American Universal shall pay to Pilot Life the amount of such excess upon receipt of a statement."

A. But that's not the insured. That's to the ceding company.

Q. Did I say to the insured?

A. Yes.

Q. I'm sorry, I meant to the ceding company.

A. All right. Well, I don't think that's uncommon, no, but whether—whether I could say that's the usual, I don't know—it's not uncommon.

Q. I am sorry, I didn't understand your answer.

A. I think this is not uncommon, no.

Q. Where is it common?

A. Well, it's common at Pilot Life Insurance Company and several dozen companies dealing in this matter, and I think also true with American Bankers and American National, it's true of Lincoln National, North American. How many companies do you need to name?

[157] Q. Is this on credit insurance?

A. Amongst other things, credit insurance.

Q. What other kind of insurance?

A. Regular insurance where there might be a co-insurance arrangement.

Q. What's a co-insurance arrangement?

A. Well, it's another type of insurance we haven't been talking about, except it's somewhat similar to the surplus relief insurance you were talking about earlier, but it's not uncommon at all to have a payment from the reinsurer to the ceding company at the outset of the program.

Q. I see. And it is typical in credit, in credit reinsurance and typical in other situations where co-insurance arrangements, similar to surplus aid treaties of the type we talked about, are in force.

Q. Is that what you said?

A. Well, I think you would find this kind of thing might be common in all similar contracts, and this might encompass almost every insurance company involving credit insurance principally during the period you are talking about. There were just a few major companies that were reinsurers in this field because they were—Old Republic being one of the leaders because they were themselves first in the credit business.

[158] One thing that might be of interest to you, the credit insurance industry is very new, as far as having—being material to the insurance industry. At the end of World War Two, there was only about a billion dollars worth of this insurance in force. The boom in the credit insurance business has been since the war, and it's been parallel to the increase in consumer credit. Today the credit insurance in force is maybe something

like seventy-five billion dollars. That's a pretty substantial increase during that period of time, from practically none to that much.

Now, Old Republic was a leader in this, Pilot was a leader in this. Several other companies that were influenced by Old Republic personnel, who gravitated to various insurance companies during this period, were beginners in it, and they offered extensions of this type of contract to essentially all insurance companies that were in the credit insurance field.

Q. Isn't this a form of surplus aid contract?

A. I don't believe that was the intention of it. I don't think that——

Q. It may not have been the intention. I am not concerned about intention, I am asking whether it is.

A. No, I think not. I think this is the reverse. Barring the first few months, there may be a payment from [159] the reinsurer to the ceding company, but this would be hardly to be expected. It would be sort of ridiculous for the Pilot Life to be expecting to get surplus relief from ITT Hamilton as it was in those days.

Q. Well, it was getting to hold the premium remitted on a monthly earned basis.

A. That's true, but that was part of their business arrangement.

Q. Well now, I want to understand to what extent the practice we are talking about was used before credit reinsurance of the type we are talking about came into being, and to be specific, talking about arrangements whereby reinsurance is paid on, quote, a monthly earned basis. But where a possibility existed under the treaty in the early months, at least, the reinsurer would remit the full commission, would be required to pay the full commission to the ceding company, and it would do so to the extent of the monthly commission. The monthly amount that it was receiving was not sufficient to cover that total commission.

Q. Now, in the physical kinds of policies you referred to before, where there was reinsurance on a monthly term basis, was this kind of term in there?

A. Well, if it was the risk premium reinsurance, no.

Q. If what?

[160] A. If it was the risk premium type reinsurance, no, because for one thing——

Q. What is a risk premium type?

A. Well, that's the most standard, most usual type reinsurance in the life insurance industry. It's where a company, A, the issuing company, or the ceding company, decides that it can't safely take more than $10,000 risk on any one individual. It sells a $15,000 policy, so it gets a reinsurer to accept the death risk, only with respect to the $5000.

You don't find this commission arrangement there because the only amount of money transmitted from this ceding company to the reinsurer is the net premium for the amount at risk, and it's just the risk premium, therefore called the risk premium reinsurance. That's really a European term for it. We call it yearly renewable term in this country, or YRT, but it was very common. As a matter of fact, it's a fundamental part of all co-insurance contracts for the reinsurer to make some sort of payments to the ceding company.

That's been in existence as long as co-insurance has been in existence, and I don't know precisely the origin of the co-insurance treaties, but I would say they date back to the 30's or 20's in this country.

Q. Well now, we have a new term here—co-insurance.

A. It all falls in the general category of reinsurance. [161] The specific name applies where the gross premium is transferred to the reinsurer rather than this net risk premium, and in that case actually the—it's very much like surplus relief. In fact, some people may consider co-insurance—may first call co-insurance surplus relief rather than co-insurance, but it's where the reinsuring company substitutes for the position of the ceding company in this first year surplus drain.

In other words, it in effect reimburses the ceding company for its expenses of underwriting and its commissions and takes only the premium which creates in the usual situation a net payment for the reinsuring company to the ceding company, and in this type of contract, since the credit insurance industry is that new, almost all of these are twenty-five years—less than twenty-five years old, you will find that almost every A and H contract, where there is credit reinsurance involved, is of this nature.

Q. So you are confining these co-insurance types of arrangements to credit insurance?

A. No, no, not at all. I was drawing a parallel between the requirement under this contract, making an initial payment from the reinsurer to the ceding company, with that same requirement under a co-insurance agreement, which have been in use considerably longer in this particular type of [162] contract.

Q. Under accident and health coverage, is the co-insurance arrangement a typical kind of reinsurance arrangement?

A. Yes, and as I say, I think this is a typical arrangement here, and if we are talking about credit, quite generally the arrangement of this same nature, which I consider co-insurance—co-insurance because the gross premium is transmitted instead of net——

Q. It's possible under some of these treaties for a negative reinsurance premium to be paid, isn't it? By that I mean a premium of more than 100% of the premium which the insurer receives—isn't that correct?

A. Well, that could come about, I believe, under these treaties in the event that the monthly earned premium was less than the claims for that month. If I might borrow the expression of the NATC subcommittee, remote but possible.

Q. I am referring to the situations where the capitalization of the reinsurance premium for deductions for expenses and claims would be more than a hundred per cent of the premium received by the ceding company.

A. Well, certainly, if they begin to have a runoff of business, that could easily be true because—or if they even come to a level production of new business, this would—[163] they would tend to be one and the same, but if there was a decline in the business of the ceding company, then this is going to be true because your block of new business continues to throw off this monthly increment and that's offset for the ceding company—it's offset, as far as their cash flow is concerned, by new premiums from new insureds.

Q. I'd like to ask a question or two about the deficiency reserves. In a situation you discussed involving deficiency reserve on direct examination, you said that at the end of—take a whole life policy, providing for annual premiums. At the end of the year the normal life insurance reserve on that policy calculated by use of tables would be upset, is that correct,

and then if it appeared that the present value of future benefits under the policies—perhaps you better——

A. Yes, I think I better, because you are going off the wrong way. If present value of future statutory premiums were more than the present value of future gross premiums, there would be a requirement for the deficiency reserve in addition to the regular reserve.

Q. Okay. And then that deficiency reserve would represent that excess for the remaining—over the remaining life of the policy, right?

A. If I can make the illustration maybe similar, this [164] was not a very uncommon thing back in the 30's, when deficiency reserves became a requirement. The valuation—the statutory term is synonymous—might have been for an ordinary life insurance policy issued at age thirty-five, say nineteen dollars a thousand. It was not uncommon for a life insurance company to be charging eighteen dollars.

Now, the deficit is simply the dollar for one year. Well, a life annuity factor on a statutory basis for policies of this nature was about twenty dollars, or twenty per dollar. So our deficiency reserve at the moment of sale would have been twenty times a dollar, or twenty dollars additional reserve requirement.

Now, the second year the policy is in force, the man is one year older. He is that much closer to death or that much closer to the end of the table. So the annuity value has decreased maybe to nineteen dollars and a half. So at the end of the second year the deficiency is a dollar times nineteen-forty-five or nineteen dollars and a half, and thus it progresses until the end of the premium paying period.

Q. Now, the reason why it decreases is the difference in the annuity value, that fifty cents that you referred to, is incorporated within the life insurance reserve addition for that period, isn't it?

[165] A. No, that's not the reason it decreases. The reason it decreases is because the present value of the difference is decreasing, and it's the present value of the difference between the premiums that you expect, statutorily, versus the present value of the premiums that you expect gross, that creates the deficiency and the amount of deficiency.

Now, at the end of the premium paying period, there is no more present value of either. Therefore, the difference has to be zero.

Q. Life insurance reserve at any period is the amount of premiums that you have already received which go to provide for coverage—not the amount of premiums, the amount of preminum necessary to segregate from the premiums you have already received or should have received under the policy in order to pay for future benefits that will not be covered by future premiums.

A. No, that's the retrospective definition, plus interest accumulated on what you held in the past.

Q. Okay. So that figure is calculated from a table, is that correct?

A. Right.

Q. What table is being used now to calculate that?

A. Well, most companies use ordinary policies, the 1958 standard ordinary table, with variance rates of interest.

[166] Q. Now, that table would create a life insurance reserve requirement as of that year on the policy without regard to the actual premium that was received. It could have been very high or very low.

A. Precisely. It's a statutory requirement. It has nothing to do with the premium being received. The only way that it is related to the premium being received, if I might make this point, is that the reserve, either life reserve, tabular reserve, if you want to call it that, or unearned premium reserve, they relate to the number of premiums or the proportion of the premiums received, not to the amount of premiums received, but the proportion of the premiums that's been received, and the proportion is related to the period of coverage for which the premium is paid. But the reserves themselves are statutory and they are artificial, and they are based on these statutory mortality tables.

Q. The life insurance reserve at the end of any one year would necessarily include a portion taken from surplus in the event that the premiums received were not sufficient to fund that reserve, although I realize we are talking about sinking funds. But if the premium were insufficient and the life insurance reserve would necessarily be composed not only of part of the premium but a part of surplus, ——

A. Well, are you referring to the deficiency reserve?

[167] Q. No, the life——

A. You are talking about a portion of the life reserve?

Q. Yes.

A. Well, to the extent that the life insurance reserve is redundant, based on mortality factors which are conservative, invariably the statutory reserve is—in effect, a portion of the statutory reserve must be realistically considered a portion of the surplus. It's just an earmarked or frozen surplus.

Q. Well, you are saying it is a portion of surplus because the company should have earned more that year, but they have to put an inordinate amount aside to compensate for the reserve requirement.

A. I hope I don't live to regret answering these questions in some other controversy, but I think that's true, and to make—to further add to your point, the AICPA, the American Institute of Certified Public Accountants, have issued their audit guide for life insurance companies and they have done precisely—they have precisely separated this portion of the reserve which might really be considered surplus because of the redundancy in the assumptions, and the portion of the reserve which realistically represents the liability, and they refer to the one that represents the liability, the true liability, is a natural reserve, and the [168] statutory reserve is an artificial conservatism imposed upon us by the statutes and must realistically be thought of as part of our surplus account.

Q. The total of those two is what is currently considered the life insurance reserve and from which these companies get deductions on their tax returns?

A. The total of those two are the statutory reserves, which are the basis for tax deductions, yes.

Q. I see.

Mr. SCHWARZ. I have no further questions.

The COMMISSIONER. Mr. Singer.

REDIRECT EXAMINATION

By Mr. SINGER:

Q. Mr. Eddy, let's continue on with this point for a moment. What would be the natural reserve in the AICPA view as far as the statutory premium reserves is concerned?

A. Well, conceptually it would be something similar. They are going to insist on not the gross unearned premium as a representation of your liabilities but something realistically appraising the true liability, and for reporting purposes you are going to be forced to show the difference, the loading, or the difference, rather, between the gross unearned and such natural reserves as earnings, or accumulatively as surplus.

[169] Q. Would the natural reserve—do you think the natural reserve would be approximately the net premium, which you referred to as the morbidity element?

A. They insist in being realistic with respect to everything. It would include not the net premium that we think of statutorily, but a real net premium related to the risk.

For instance, in the life insurance, we might put forty-five cents out of a dollar at issue date or decreasing term as a pretty close approximation to the average statutory reserve requirement, but we know in this business that claim ratios seldom get above 30%. So thirty cents might be then the natural reserve, but then we must also take into account probability of termination and, therefore, the need for refund of the difference. So we would have to establish those probabilities, and what that would amount to, it may come up to a fifteen cent requirement and then we are back to the forty-five cents, but we would determine it on a different basis.

Q. Are you talking just about life insurance reserve?

A. I just gave that as an illustration because it was easier.

Q. What about the unearned premium? Can you give a——

A. I meant that on the unearned premium on the net [170] basis. The same thing applies on the gross earnings—an unearned net. The gross unearned net would be nothing more than the statutory measure, for reporting purposes, and accounting people would consider something much less if you need the true reserve.

Q. But from an actuarial standpoint again, as a measure of the insurance risk, the unearned premium reserve, the gross unearned premium reserve, in your opinion, is excessive?

A. I believe—yes, that is certainly in my case—I believe that is shared by most actuaries.

Q. And the amount of the—the excess in your opinion is the loading?

A. That is correct. We refer to it as loading. It's really—represents monies for expenses and profits and, of course, most expenses on credit insurance have already been incurred at the outset.

Q. And getting back to the life insurance reserve, the life insurance reserve does not have any comparable loading type feature built into it as the unearned premiums does?

A. That's right, except in redundancy in the statutory factors, but the statutory reserve really only measures the risk insured against the statutory table.

Q. I take it that if the unearned premium was based on an older morbidity table than that, there would be a redundancy [171] factor even in the net premium of the unearned premium?

A. That's right.

Q. You testified during cross-examination that under a practice which arose subsequently to the years in suit here, if an insurance company ceded insurance, single premium, received a dollar from the policy holder, and then ceded fifty-five cents as a single premium for the entire portion of the policy reinsured, the type of policy term, the reinsurer would then set up on its books an unearned premium reserve under this new practice of a dollar. Is that a fair representation?

A. Yes. I don't think that is universal at this point. I don't think it is really an absolute requirement of all states at this point, but the companies who vary in their practice have to reflect that variance in the statements they produce.

Q. Well, suppose here—it would be hypothetical, but let's be realistic in the sense that we are looking at the treaties between ITT Hamilton and Old Republic, Pilot, and National Fidelity. Assume those provisions apply, and the hypothetical part of this question would be, assume that Old Republic, say, only paid over the term of the premium, only paid 55%. Would your conclusion, that you stated earlier, that ITT Hamilton is not required to set up an unearned [172] premium reserve, be different if these monthly earned premiums which were received only totaled fifty-five cents at the end of the policy?

A. I'm not sure I understand the question, but if you are saying that the amount of the premium that Old Republic remits to ITT Hamilton under these agreements on a monthly basis alters the reserve requirement, I say no. The reserve re-

quirement under this treaty would be zero at the end of each month regardless of how much premium in dollars and cents is remitted from Old Republic to Hamilton, or to ITT Hamilton, with respect to each month's coverage, because it measures—this is after the fact, this is on an earned basis.

Q. And would your conclusion be any different if—let's assume that under the Old Republic or one of the three treaties, or all of them, Old Republic was legally bound in some way to pay premiums on a monthly basis, and could not, as in perhaps a life insurance contract, could not simply stop paying premiums and not receive further insurance, does this have any bearing at all on whether ITT Hamilton is required to set up an unearned premium reserve?

A. No, it does not. In my opinion the unearned premium measures the proportionate part of an unexpired period of coverage, and this treaty, all these treaties, the ITT Hamilton didn't receive any premium before the expiration date of the [173] coverage.

Q. All right. Mr. Eddy, I am going to repeat myself. I want to make sure that after having heard the questions put to you by Mr. Schwarz and having considered all the factors that he brought up, whether the opinion you expressed earlier today, that ITT Hamilton is not, either from an actuarial standpoint or from a state regulatory standpoint, was not required or indeed permitted to set up unearned premium reserves under these treaties, whether you still hold that opinion.

A. I certainly still hold that opinion. ITT Hamilton had no unearned premium reserve requirements, either from an actuarial point of view or from a regulatory point of view, in my experience.

Mr. SINGER. All right, that's all

The COMMISSIONER. Anything further?

Mr. SCHWARZ. I just have about two questions.

The COMMISSIONER. All right.

RECROSS-EXAMINATION

By Mr. SCHWARZ:

Q. Can you think of any situation involving insurance, and not reinsurance, where, except for the examples you gave me

before involving either delay or late payment of a premium due at the outset of coverage or delay in paying because of a grace period specified in the policy, where a company will [174] accept a liability when it has not received the premium for that liability, unconditional liability at the outset of the coverage, or where it doesn't have a right to receive it at the outset of the coverage on the policy?

A. No, I don't believe so. The only thing that would remotely be similar to that would be the case where you have casualty type coverages, where the premium is—the final premium is not established until the expiration of the contract. This is generally with corporations, large types of coverages, fire and casualty type coverages, but even then I don't think that there is any—I am certain the insurers always have a right to the premium from the outset and they always collect some sort of advance against the premiums, usually pretty well calculated to be nearly what's going to be required.

Q. I have one other question. I would like to compare the reserve requirements under a group—under a term life insurance policy, with an accident and health policy of relatively short term. Let's take an example involving a four year term insurance policy, which is renewable yearly at a specified annual premium. Compare that on the one hand with an accident and health policy, four year accident and health policy, also renewable by paying the stated premium every year. What kind of a reserve must the insurance company [175] establish on that term insurance policy at the end of the first year?

A. This is an annual premium?

Q. Yes.

A. And when you said at the end of the first year, you mean at the expiration of exactly twelve months from the beginning of the policy?

Q. All right, fine.

A. The reserve requirement would be zero.

Q. Now, let's say the policy is taken out July 1st, and 12–31 is the valuation day.

A. Then it would be fifty cents on the dollar.

Q. On which policy?

A. On the life—the term. Not on the gross basis, however, but on a net risk premium basis.

Q. That would be the life insurance reserve?

A. Yes. So we might say if—it depends on the company's pricing structure, but let's suppose that the net risk premium is fifty cents and the commission and expenses and profits fifty cents. Then issuing it on July 1, a 12–31 valuation would have half of the period unexpired, and on a net premium basis it would be one-half of fifty cents remaining, or twenty-five cents reserve account.

Q. I see. And under the A and H example, it would be [176] a gross reserve?

A. That's correct, it would be fifty cents in the same situation.

Q. I see. Now, if you had a long term A and H policy, comparable to a whole life insurance policy at the end of the year that we are referring to, how would you set up the reserve comparably?

A. You had a long term?

Q. You had a whole life policy and you had a policy which is considered non-cancelable under the industry's definition of the term, which you stated earlier, which was stated to you in direct examination, what would be the comparable reserve requirements under both policies?

A. Well, under the life insurance policy, because—we are speaking of level premium life insurance—the policy holder pays the same premium every year—you would have a portion of the first premium would have to be reserve and set aside to earn interest, so at the end of six months you have whatever reserve, and there are some technicalities on this, but I think in concept this is sufficient. In the case of an A and H policy, ——

Q. Wait a second. In the case of the life, it is a net reserve, is it?

A. It's based on the valuation, on the statutory [177] reserve requirement, yes.

Q. Which is net?

A. Right. In the case of the accident and health policy, you could have two situations. We have to further define long term, or we have to——

Q. Let's say the policy—I said the policy is noncancelable within the industry definition of the term.

A. Within the industry definition of non-cancelable, at the end of the first six months of the policy, which is the illustration here, you would have one-half of the first premium on a gross basis, and comparably you would have a reserve, a por-

tion of the premium of the first year set aside to be accumulated at interest.

Q. Now, is this example you give a typical example?

A. With the reservation that because of a peculiar method of calculating the tabular reserves, ——

Q. Well, regardless of that typical example.

A. I've got to give you the reservation because that's not typical, except in concept. In concept that's exactly what happens. But specifically the life policy, the reservation of the position of the life premium wouldn't commence until the beginning of the second year. The A and H doesn't start until the second or third year, but conceptually you would have no excess in the first year, the first two years, [178] as an illustration.

Q. Yes, but your statements reflect what your original answer to my question was, not what is conceptual. The annual statement filed with the commissioners and the tax return prepared on that same basis would show what you said it would show.

A. Yes, in concept it would show in one case, a life reserve which is net, and it was a small portion of the first premium reserve, accumulated, and in the A and H it would show one-half of the gross premium paid that year plus a small portion, generally zero at the first year, with a small portion reserved in the A and H policy calculated in a similar manner to the life reserve.

Q. What are the names of the two you referred to in the A and H policy?

A. Well, the unearned premium, the unearned gross premium, is half of the gross premium, and I think the actuaries may vary in what they would call the other, but in the convention blank it is—Exhibit 9—they have a line which they refer to as additional reserve, guaranteed renewable, non-cancelable policy. That's not a very descriptive name, but that's what they call it.

Mr. SCHWARZ. I have no further questions.

By the COMMISSIONER:

[179] Q. Mr. Eddy, no pun intended—I suppose this might be called a morbid question—but would you tell me what morbidity means in the insurance industry as applied to these types of policies you have been speaking of?

A. All right. To me, and I think this represents other actuarial viewpoints, morbidity refers to the probability of becoming disabled or sick, and mortality refers to the probability of dying. Those are the differences in the two.

Q. And they do have statistical information with respect to what the probability of becoming ill is, being in an accident?

A. Yes, sir, quite exhaustive statistics.

Q. That's interesting. Thank you very much, Mr. Eddy.

A. Thank you, sir.

Q. You may step down.

[Witness excused.]

The COMMISSIONER. Anything further, Mr. Singer?

Mr. SINGER. I think I will turn it over to Mr. Jones now.

The COMMISSIONER. All right.

Mr. JONES. Well, we are ready to close the record if the Government is. I don't know if they have any additional plans or not.

The COMMISSIONER. How about it, Mr. Schwarz?

[180] Mr. SCHWARZ. We wanted to stipulate as to the method by which the premium was remitted to the insurer, and I'm not sure——

Mr. JONES. A supplemental stipulation we discussed earlier this morning.

Mr. SCHWARZ. It will still be?

Mr. JONES. Yes. We have nothing further to introduce that has not been mentioned here today. The supplemental stipulation and the transcript, of course, is part of the record. I will restate it. We have no further witnesses to offer if the Government has no further witnesses to offer.

Mr. SCHWARZ. We have none.

The COMMISSIONER. All right. Then the proof is closed with the exception of the remaining opening for the purpose of the supplemental stipulation, and I believe also a stipulation with respect to Mr. Eddy's expertise. When the reporter has gotten this transcript done up for us and filed, I will file a formal notice of closing of proof, which will start your time running for requested findings.

Mr. JONES. Would it be appropriate to talk to the time limits?

The COMMISSIONER. Certainly.

Mr. JONES. This is a complicated case. We are anxious to get it done, and I can see us doing it within thirty days, but I

would be awfully annoyed if I am banging my head for thirty days to get it out, or Mr. Singer had thirty days and the Government took ninety or 120 days. We would accommodate ourselves to any period the Government thinks is reasonable for these briefs, but we hope it would end up at least roughly comparable in time, and if the Government proposes to file its brief thirty days after ours, that's fine. If he wanted an extension, I would prefer to know it now,—maybe forty-five days for each other, or maybe even sixty days, but I would be guided by the Government's suggestion.

Mr. SCHWARZ. Well, I don't want to direct your result by mine. How much time would you like?

Mr. JONES. I would like the same amount of time that you have.

The COMMISSIONER. I don't think we need this on the record, Mr. Reporter.

[Off-the-record discussion.]

The COMMISSIONER. All right, thank you very much, gentlemen.

[Whereupon, at 4:00 p.m. the hearing in the above-entitled matter was concluded.]

STIPULATION OF QUALIFICATIONS OF ARTHUR C. EDDY AS EXPERT WITNESS

(Number and title omitted)

By agreement of counsel for Plaintiff and Defendant, the following qualifications of Mr. Arthur C. Eddy are submitted in lieu of a voir dire examination:

1. Mr. Eddy attended the University or South Carolina and received a Bachelor of Science degree (in Mathematics) from that University in 1946. He spent approximately 14 years (from 1948 to 1962) with the Pilot Life Insurance Company of Greensboro, North Carolina. He joined the company as a clerk in its actuarial department and was its second Vice President and Associate Actuary when he left. He has been a consultant to the insurance industry since 1962, first with the firm of Bowles, Andrews and Towne and, since 1970, with the firm of Towne & Eddy, both of Atlanta, Georgia. Mr. Eddy is a Fellow of the Society of Actuaries.

2. Mr. Eddy's duties at Pilot Life included computation of insurance reserves and preparation of Annual Statements for submission to the insurance departments of 16 or 17 states in which Pilot was qualified to do business, including the State of Missouri. As a consultant, Mr. Eddy has advised numerous insurance companies on policies, reserves, and the regulatory requirements of the states. He is familiar with the standard valuation laws in force in all fifty states, and with the requirements and examination procedures of the National Association of Insurance Commissioners. He is also familiar with business practices in the insurance field generally and in the credit insurance industry in particular.

3. Mr. Eddy has testified as an expert witness on credit insurance matters in the case of *Alinco Life Insurance Co.* v. *United States*, in 1965, before The Honorable Lloyd Fletcher, Commissioner of the Court of Claims, and in the case of *Superior Life Insurance Company* v. *United States*, in 1970, in the United States District Court for the District of South Carolina, and other cases.

Respectfully submitted,

OWEN T. ARMSTRONG,
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ROGER A. SCHWARZ,
Attorney for Defendant.

AMENDMENT TO STIPULATION OF FACTS

(Number and title omitted)

(Filed: December 30, 1971)

Plaintiff, ITT Hamilton Life Insurance Company, and Defendant, United States of America, jointly move to amend the stipulation of facts submitted by the parties on August 6, 1971 in the following respects:

1. Paragraph 27 of the stipulation of facts shall be amended by deleting the year "1962" from the penultimate sentence of the second paragraph of paragraph 27 (page 15 of the stipulation). As amended, paragraph 27 shall read as follows:

"27. Several methods can be used to arrive at a value for the unearned premium reserve where many policies are outstanding at the statement date. The most precise would be to determine the exact date of issuance of each outstanding policy so that the unexpired portion of each policy in force at the statement date can be ascertained. However, the cost and time involved in making such a computation is prohibitive to companies without sophisticated data processing equipment. Therefore, assumptions are commonly made as to the dates on which outstanding policies were issued.

The unearned premium reserves maintained by Old Republic, Pilot, and National Fidelity on credit accident and health insurance covering debtors of Aetna and its subsidiaries, as well as the unearned premium reserves maintained by Plaintiff under its reinsurance treaty with Insurance City, were computed monthly on the assumption that all policies issued during a particular month were issued at the end of the month. For example, if Old Republic received $100,000 in accident and health premiums during the month of December with respect to the issuance of credit life, accident and health policies to Aetna loan customers, its unearned premium reserves were computed on the assumption that all of such policies were issued on December 31, and that the $100,000 in premiums were likewise received on December 31. The Internal Revenue Service has recomputed such unearned premium reserves maintained by Old Republic, Pilot, National Fidelity and Plaintiff at December 31, 1963, 1964 and 1965, using an assumption that all policies issued during a given month were issued on the 15th day rather than the last day of such month. Plaintiff does not contest such adjustments."

2. The following new paragraphs numbered 59 and 60 shall be added to the stipulation:

"59. Under Plaintiff's reinsurance treaties with Pilot and National Fidelity, there would be deducted from the reinsurance premiums payable to plaintiff each month, the charge for the total commissions and pre-

mium taxes paid with respect to policies and certificates of insurance issued by those companies during the previous month. Commissions and premium taxes were based upon the full premium charged on such policies and certificates, whereas the monthly reinsurance premiums receivable by Plaintiff under the above treaties were based upon the portion of premiums defined in the treaties as earned in the previous month. Thus, the first few monthly reinsurance premiums receivable by Plaintiff with respect to a newly issued policy or certificate would normally be less (individually and in the aggregate) than the related amount of premium taxes and commissions deducted from Plaintiff's reinsurance premiums for the month in which the policy or certificate was issued. The aggregate amount of monthly reinsurance premiums receivable by Plaintiff with respect to all outstanding policies and certificates theretofore issued during the treaty period under the above reinsurance treaties exceeded amounts deducted for taxes and commissions within a few months after the inception of the treaty period."

"60. At the end of each month, Aetna prepared a check payable to the appropriate ceding company in the amount of the adjusted gross premiums collected on behalf of the ceding company during the month less commissions paid. The check would either be mailed to the ceding company (as was true in the case of Old Republic and Insurance City) or deposited in a bank account of the ceding company (as was true in the case of Pilot and National Fidelity)."

Respectfully submitted,

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SCOTT P. CRAMPTON,
Assistant Attorney General, Tax Division.

_____ _____,
Attorney for Defendant.

Supreme Court of the United States

No. 75–1285

UNITED STATES, PETITIONER

v.

PENN SECURITY LIFE INSURANCE COMPANY

Order allowing certiorari

(Filed May 24, 1976)

The petition herein for a writ of certiorari to the United States Court of Claims is granted. The case is consolidated with Nos. 75–1221 and 75–1285 and a total of one and one-half hours is allotted for oral argument.

Supreme Court, U. S.
FILED
APR 8 1976
MICHAEL RODAK, JR., CLERK

No. 75-1285

IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

UNITED STATES OF AMERICA, *Petitioner*

v.

PENN SECURITY LIFE INSURANCE COMPANY, *Respondent*

Petition for a Writ of Certiorari to the United States Court of Claims

---

BRIEF OF RESPONDENT IN OPPOSITION

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April 1976

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IN THE

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Petition for a Writ of Certiorari to the United States Court of Claims

---

BRIEF OF RESPONDENT IN OPPOSITION

OPINION BELOW

The opinion of the Court of Claims is reported at 524 F.2d 1155 and reproduced, with the Court of Claims' findings of fact, in the Appendix to the Petition for Certiorari.

QUESTION PRESENTED

The ultimate question in this case is whether Respondent qualified as a "life insurance company" during the years in issue under Section 801 of the Internal Revenue Code of 1954. Section 801 defines a life insurance company as an insurance company with life insurance reserves comprising more than 50% of its

total reserves. Respondent satisfied that reserve ratio test on the basis of the reserves it actually held in conformity with the requirements of state law.

The question presented is whether the Court of Claims correctly declined to include in the reserve ratio unearned premiums "attributed" to Respondent from unrelated companies whose risks it reinsured where (1) Respondent had no right to receive unearned premiums (as defined by Treas. Reg. § 1.801-3(e)) under its agreements with the reinsured companies, (2) Respondent did not own or control the reinsured companies nor did it otherwise actually or constructively hold the unearned premiums at any time, and (3) Respondent was not required by state law to maintain an unearned premium reserve on these reinsured risks.

STATUTES AND REGULATIONS INVOLVED

All of the statutes and regulations involved are set forth in the Petition for Certiorari, pp. 2-5,[1] with the exception of the following critical provision of the regulations.

> Treas. Reg. Sec. 1.801-5. Total reserves.—
>
> (a) *Total reserves defined.* For purposes of section 801(a) and § 1.801-3, the term "total reserves" is defined in section 801(c) as the sum of—
>
> (1) Life insurance reserves (as defined in section 801(b) and § 1.801-4),
>
> (2) Unearned premiums (as defined in paragraph (e) of § 1.801-3), and unpaid losses (whether or nor ascertained) (as defined in paragraph

[1] Reference to the Petition for Certiorari will hereafter be made in the form "(Pet., p. —)."

(g) of § 1.801-3), not included in life insurance reserves, and

(3) All other insurance reserves required by law.

The term "total reserves" does not, however, include deficiency reserves (within the meaning of section 801(b)(4) and paragraph (e)(4) of § 1.801-4), even though such deficiency reserves are required by State law. In determining total reserves, a company is permitted to make use of the highest aggregate reserve required by any State or Territory or the District of Columbia in which it transacts business, *but the reserve must have been actually held during the taxable year for which the reserve is claimed.* For example, during the taxable year 1958 a life insurance company sells life insurance and annuity contracts in States A and B. State A requires reserves of 10 against the life and 5 against the annuity business. State B requires reserves of 9 against the life and 7 against the annuity business. Assuming the company actually holds these reserves during the taxable year 1958, its highest aggregate reserve for such taxable year is the 16 required by State B. Thus, the company is not permitted to compute its highest aggregate reserve by taking State A's requirement of 10 against its life insurance business and adding it to State B's requirement of 7 against its annuity business. (Emphasis supplied).

STATEMENT

In brief summary, Respondent's principal business during the years in issue consisted of reinsuring risks underwritten by unrelated insurance companies in respect of credit life insurance policies issued by those companies to borrowers from Respondent's parent, a finance company. (Finding 4; Pet., p. 31a). Some

credit life policies included disability benefits, and these benefits were reinsured separately by Respondent. (Findings 13, 18; Pet., p. 36a, 40a).

Under its disability reinsurance agreements ("treaties") with the reinsured ("ceding") companies, Respondent received a monthly reinsurance premium solely for insurance coverage provided during the preceding month. (Finding 18; Pet., p. 40a). The ceding companies retained the unearned premiums received from their policyholders, as well as the income earned on those funds, and were accordingly required under state law to maintain unearned premium reserves on their policies. (Finding 16; Pet., pp. 38a-39a).

The Court of Claims, sitting *en banc,* rejected Petitioner's argument that unearned premium reserves held by the ceding companies should be attributed to Respondent under a "reserves-follow-the-risk" rule. The Court pointed out that charging Respondent with "unearned premiums" when it never received premiums paid in advance was contrary to the Treasury's own definition of the term.[2] Further, applying an attribution rule in Respondent's case, when it neither actually nor constructively held the ceding companies' unearned premiums, was inconsistent with the statute, the regulations, one of the Internal Revenue Service's own rulings,[3] and the rules and practices followed by state regulatory authorities in determining reserve requirements.

---

[2] *See* Treas. Reg. § 1.801-3(e) providing that the term unearned premiums "means those amounts which shall cover the cost of carrying the insurance risk *for the period for which the premiums have been paid in advance . . .*" (Emphasis supplied).

[3] *See* Rev. Rul. 70-508, 1970-2 C.B. 136.

The Petition gives a fuller statement of the case (Pet., pp. 5-10), but contains an error that undermines the very basis of Petitioner's argument for certiorari.

The facts in *Economy Finance Corp.* v. *United States,* 501 F.2d 466 (7th Cir. 1974), *cert. denied,* 420 U.S. 947 (1975), were *not* "identical" to the instant case as characterized by Petitioner (Pet., p. 9). Although in both cases the terms of the disability treaties provided for payment of monthly reinsurance premiums as earned, the Court of Claims pointed out that in *Economy Finance* the actual facts were "quite different."

> "[T]he facts in *Economy Finance Corporation* differed from those in the present case in one important respect. Those taxpayers had agreements with the ceding company under which the latter was required to invest most of the unearned premium reserves in subordinated debentures of the parent of one of the taxpayers, and then to turn over the interest income received on those debentures as an 'additional commission' to the insurance agency partnership composed of stockholders of one of the related taxpayers. *See* 501 F.2d at 470. Thus, the *Economy Finance* taxpayers in effect received the proceeds of the unearned reserves even while in the hands of the ceding company. That arrangement was *quite different* from the one involved in the case at bar and could be understood as making that ceding company the agent of those taxpayers." (Pet., pp. 15a-16a) (Emphasis supplied).

In the present case, the Court of Claims found that the ceding companies were not agents of Respondent (Pet. p. 20a), and that "[Respondent] did not obtain or use the unearned premiums reflected in the statements of the ceding companies nor were such unearned pre-

miums credited, set apart or made available to [Respondent]." (Finding 16; Pet., p. 39a).

One final point. Petitioner's Statement does not inform the Court that more than half the dollar value of benefits reinsured by Respondent under these treaties were life insurance benefits (Finding 13; Pet., p. 36a), and that, even after attribution, more than half the reserves needed to cover the cost of carrying the life and disability risks ceded to Respondent would be life insurance reserves. (Finding 34, Pet., p. 52a). The benefits asserted for Petitioner's "reserves-follow-the-risk" rule are worth pondering when its effect would be to exclude a company insuring primarily life insurance risks from life insurance company status.[4]

---

[4] This result occurs because life insurance reserves are computed on a *net* premium basis, taking into account only the cost of carrying the insurance risk, while unearned premium reserves on accident and health coverage have traditionally been computed on a *gross* basis to include not only the cost of carrying the risk but also "loading" costs including commissions, overhead, and profit. (Finding 32, Pet., p. 50a). With such an apples versus oranges comparison, an insurer writing approximately equal amounts of life and accident and health insurance over the same term will always have substantially more accident and health unearned premium reserves than life insurance reserves.

Despite pious protestations by Petitioner that it is only interested in reflecting *risks* assumed in the reserve ratio test, it maintained below that the ceding companies' unearned premiums should be attributed to Respondent on a *gross* basis, notwithstanding the Court's finding that the "loading" portion of the attributed unearned premium reserves is not a true insurance reserve at all but merely a solvency reserve. (Finding 32, Pet., p. 50a). Respondent argued that "gross attribution" was inconsistent with the theory of Petitioner's "reserves-follow-the-risk" rule, and that in any event Treas. Reg. § 1.801-3(e) limited the unearned premiums includible in the reserve ratio to that portion needed to "cover the cost of carrying the insurance risk." The Court of Claims found it unnecessary to reach these arguments in view of its conclusion that no attribution was justified in Respondent's case.

REASONS FOR DENYING THE WRIT

This Court should not accept Petitioner's invitation to rewrite a specialized statutory tax scheme in a technical area where the issues have been settled by Petitioner's own regulations for over 50 years. No conflict of decisions compels the Court's review; as noted, *Economy Finance* and this case were not decided on "identical facts" and the decisions can be reconciled. The Court of Claims' decision affects only a segment of a single industry and the revenue impact is insignificant compared with other current tax issues affecting the entire life insurance industry. Petitioner itself opposed certiorari when the taxpayer in *Economy Finance* petitioned for review barely a year ago.

The attribution of unearned premiums by the Seventh Circuit in *Economy Finance* can be justified on traditional agency grounds because the reinsurers there actually or constructively received the unearned premiums by reason of a side-agreement with the ceding company. See p. 5 *supra*. *Compare Superior Life Insurance Co.* v. *United States*, 462 F.2d 945 (4th Cir. 1972), similarly distinguished by the Court of Claims on the grounds, *inter alia*, that attribution could be justified on agency or constructive receipt principles:

> ". . . None of the facts on which the decision in *Superior Life* turned—(1) the agency relationship between the holder of the premiums and the insurance company, (2) the free availability of unearned premiums to the insurance company, and (3) identity of control between the parent-agent and subsidiary-insurance company—is present here. Since the taxpayer in *Superior Life* 'constructively received' unearned premiums under long-accepted principles of tax law, the Fourth Circuit's decision is entirely consistent with the

fact that the existence of unearned premiums depends upon the mode of premium payment." (Pet., pp. 19a-20a).

Thus, there is no square conflict between this case and *Economy Finance* or *Superior Life*. The Court of Claims has indicated it would have reached the same result as the Fourth and Seventh Circuits if presented with the very different facts of those cases.

To be sure, the Seventh Circuit rationalized its decision not on agency grounds but on the Government's "reserves-follow-the-risk" argument. That it used the wrong reason to reach a justifiable result does not create a conflict with *Penn Security,* however. The Seventh Circuit was misinformed regarding the statutory scheme,[5] and was presented with an extreme set of facts. It may correct itself if a case with *Penn Security's* facts is ever brought before it. If it or some other appellate court should subsequently impose attribution where the facts do not justify that conclusion

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[5] The Seventh Circuit apparently believed it had to rewrite the life insurance company definitional test because no other mechanism was available to prevent abuses of the deferral privilege accorded to companies who qualify for life insurance company tax treatment. The Government had argued that once a company qualifies for the benefits of life insurance company taxation, the deferral privilege cannot be terminated until the company itself "takes appropriate actions." See Economy Finance Corp. v. United States, *supra,* 501 F.2d at p. 476. The Seventh Circuit was not told that Congress had provided its own mechanism for guarding against abuses of the statutory scheme by placing statutory limitations on the deferral privilege even when a company meets the life insurance company definitional test. See § 815(d)(4), I.R.C. 1954. Nor was it informed that Congress was quite aware of reinsurance arrangements in which the ceding company holds reserves on reinsured risks, yet provided only a limited, *optional* attribution rule for this situation. See section 820, I.R.C. 1954; *compare* Rev. Rul. 70-508, 1970-2 C.B. 136.

on agency or constructive receipt principles, this Court may then consider whether it wants to review the issue.

For decades, Petitioner's own regulations have restricted reserves which may be taken into account in the reserve ratio test to those "actually held [by the company] during the taxable year," Treas. Reg. §1.801-5(a)(3), and have limited "unearned premiums" to situations in which the company has been actually "*paid* in advance." See Treas. Reg. § 1.801-3(e). There can be no question that this is a valid interpretation of a statute (§ 801(a)) which tells each company to compare "its" life insurance reserves with "its" total reserves. It is equally clear that the regulations leave no room for an attribution rule that is not based on actual or constructive receipt by the company sought to be charged with the reserve.

Further, Treasury regulations and the courts have long looked to state law to determine the amount of reserves allowable under the reserve ratio test. *See* Treas. Reg. § 1.801-5(a)(3), p. 3 *supra; Alinco Life Insurance Co.* v. *United States,* 373 F.2d 336, 345 (Ct. Cl. 1967). Never before has the Internal Revenue Service imputed a reserve to an insurance company in the face of uncontradicted evidence that the reserve was neither held by the insurance company nor required by the state authorities charged with monitoring the adequacy of that company's reserves.[6] Petitioner would

[6] Petitioner's recent contention that the reserves it seeks to attribute were "required by law," despite the Court of Claims' finding to the contrary (see Pet., p. 12 n. 5), is disingenuous at best in view of Petitioner's many representations below that it did not consider state law at all relevant on the attribution issue. We assume in any event that Petitioner is not asking this Court to devote its time to reviewing the decision of the Court of Claims on a point of Missouri insurance law.

usurp the legislative function of changing statutory and administrative law of 50 years standing without so much as giving affected taxpayers notice of the change under appropriate rule-making procedures.

In its petition in the companion case of *Consumer Life Insurance Co.* v. *United States,* 524 F.2d 1167 (Ct. Cl. 1975), petition for a writ of certiorari pending, No. 75-1221, Petitioner states (p. 14) that $28 million of taxes are at stake in cases involving "the issue."[7] While $28 million is not a trivial amount, the issues here cover a number of years going back at least to 1958 (as in *Consumer Life*) so that the average amount of taxes would seem to be less than $2 million per year. By contrast, the Solicitor General recently requested an extension of time in which to file a petition for certiorari in another life insurance company case, *Standard Life & Accident Insurance Co.* v. *Commissioner,* 525 F.2d 786 (10th Cir. 1975), where, we have been informed, the revenue impact of the issues in dispute is estimated in the range of 100 million dollars *per year.* In the event Petitioner does seek review of the *Standard Life* case, the Court may also wish to consider whether it should hear two cases involving only the taxation of life insurance companies in a single term.

Since Petitioner sees the need for a "uniform national rule" on the issue in this case (Pet., p. 11) it is worth noting that the Court of Claims is a court of na-

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[7] As noted below, *Consumer Life* actually raises two entirely separate issues. Petitioner does not specify what portion of the $28 million figure arises from the Penn Security attribution issue as opposed to the Consumer Life "substance over form" issue.

tional jurisdiction to which all taxpayers have access.[8] That Court has already considered the attribution issue carefully and with great deliberation. More than 21 months elapsed between argument and decision in this case, during which time there were two sets of supplemental briefs filed and a rehearing *en banc*. Given the technical complexity and limited importance of the issue, the Court should not use its limited and valuable resources to duplicate the Court of Claims' efforts when that Court has already given the companies affected not only a "uniform national rule" but a correct one.

Brief mention should be made of the Fifth Circuit's decision in *First Railroad & Banking Co.* v. *United States,* 514 F.2d 675 (5th Cir. 1975), a case which Petitioner tells us "followed" *Economy Finance.* That case involved not only different facts from the instant case but a totally different issue. The taxpayer was not a reinsurer like Respondent but a company issuing its own insurance policies to individuals and actually receiving unearned premiums paid in advance from its policyholders. Thus, the critical Treasury Regulations referred to herein were not at all involved, for the taxpayer could not maintain—as Respondent did successfully in the case at bar—that it never received "unearned premiums" as defined in Treas. Reg. § 1.801-3 (e) and that it never "actually held" such reserves as required by Treas. Reg. § 1.801-5(a)(3).

---

[8] Petitioner concedes as much in its petition in the *Consumer Life* case (at p. 14) when it says that "since any insurance company may sue for a refund in the Court of Claims and invoke the authority of its decision in this case, the fiscal significance of the decision below potentially encompasses every pending case involving the issue."

The issue in *First Railroad* was whether the reinsurance label under which the taxpayer transferred unearned premiums to its parent company, the reinsurer, was *bona fide* or merely a facade for an agency relationship between the taxpayer and its parent. The taxpayer in *Consumer Life* was also the ceding company under a similar treaty,[9] but there was no parent-subsidiary relationship with the reinsurer in its case. *Compare Superior Life Insurance Co.* v. *United States, supra* and *cf.* section 482, I.R.C. 1954. In all events, no arrangement resembling the facts in *First Railroad* or Treaty II in *Consumer Life* was present in the case at bar. Petitioner's entire argument here is based on an acceptance of the substance of the reinsurance treaties between Respondent and the independent insurance companies.

Petitioner's suggestion (Pet., p. 13 n. 6) that the Court hold this case pending its disposition of *Consumer Life* is utterly inappropriate. Even if the Court finds a conflict on the substance-over-form issue raised in *First Railroad* and *Consumer Life's* Treaty II, there is no reason why the Court should not deny the Petition in this case.

On the other hand, should the Court decide to hear arguments on the attribution issue raised in *Penn Security,* Respondent should clearly be given an opportunity to be heard. *Penn Security* was the lead case in the Court of Claims; the "unearned premium" attribution issue in *Consumer Life* was decided on the authority of *Penn Security* (*see* Petition in *Consumer Life,* p. 81a).

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[9] Referred to by the Court of Claims as Treaty II. In addition Consumer Life acted as reinsurer under a treaty similar to that in the instant case, referred to by the Court as Treaty I.

Furthermore, in *Penn Security* Petitioner is faced with a record which nicely illustrates the arbitrary and unpredictable nature of its "reserves-follow-the-risk" theory. Since the cost of carrying Respondent's life insurance risks comprised more than 50% of the cost of all reinsured risks, it is much more difficult for Petitioner to argue that rewriting the statute and regulations so as to disqualify Petitioner from life insurance company status will somehow produce a result more clearly in line with a presumed Congressional "intent."*

CONCLUSION

For the reasons stated above, the Petition for a Writ of Certiorari should be denied.

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April 1976

* It would be particularly unjust to sacrifice Respondent's interests to Petitioner's litigating strategy when the amount of taxes Respondent has at stake in this case is more than 3½ times as great as the taxes at issue in Consumer Life. *See* Petition, pp. 57a-59a and *compare* Petition in *Consumer Life*, p. 92a.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 75-1285

UNITED STATES OF AMERICA, *Petitioner*

v.

PENN SECURITY LIFE INSURANCE COMPANY, *Respondent*

On a Writ of Certiorari to the United States Court of Claims

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 75-1285

UNITED STATES OF AMERICA, *Petitioner*

v.

PENN SECURITY LIFE INSURANCE COMPANY, *Respondent*

On a Writ of Certiorari to the United States Court of Claims

BRIEF FOR RESPONDENT

QUESTIONS PRESENTED

Where "bona fide reinsurance agreements" do not entitle a reinsurer to receive premiums "paid in advance" for insurance coverage in future periods from the companies it reinsures, may the Internal Revenue Service include "unearned premiums" with respect to such agreements in the reinsurer's reserves in disregard both of its own Regulations, Treas. Reg. Sections 1.801-3(e), 1.801-5(a)(3), 1.801-5(b), and the regulatory requirements of state law?

Does either Section 801 of the Internal Revenue Code or the doctrine of "substance over form" justify attri-

bution of unearned premium reserves from reinsured companies to an unrelated reinsurer where, under bona fide reinsurance agreements, the reinsured companies actually hold the reserves in satisfaction of contractual and statutory obligations to their policyholders, and the reinsurer has no right to hold, is not required to hold, and does not in fact hold those reserves at any time?

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954

Sec. 801. DEFINITION OF LIFE INSURANCE COMPANY

(a) LIFE INSURANCE COMPANY DEFINED.—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—

(1) its life insurance reserves (as defined in subsection (b)), plus

(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves (as defined in subsection (c)).

* * *

(c) TOTAL RESERVES DEFINED.—For purposes of subsection (a), the term "total reserves" means—

(1) life insurance reserves,

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) all other insurance reserves required by law.

The term "total reserves" does not include deficiency reserves (within the meaning of subsection (b)(4)).

* * *

Sec. 820. OPTIONAL TREATMENT OF POLICIES REINSURED UNDER MODIFIED COINSURANCE CONTRACTS

(a) IN GENERAL.—

(1) TREATMENT AS REINSURED UNDER CONVENTIONAL COINSURANCE CONTRACT.—Under regulations prescribed by the Secretary or his delegate, an insurance or annuity policy reinsured under a modified coinsurance contract (as defined in subsection (b)) shall be treated, for purposes of this part (other than for purposes of section 801), as if such policy were reinsured under a conventional coinsurance contract.

(2) CONSENT OF REINSURED AND REINSURER.—Paragraph (1) shall apply to an insurance or annuity policy reinsured under a modified coinsurance contract only if the reinsured and reinsurer consent, in such manner as the Secretary or his delegate shall prescribe by regulations—

(A) to the application of paragraph (1) to all insurance and annuity policies reinsured under such modified coinsurance contract, and

(B) to the application of the rules provided by subsection (c) and the rules prescribed under such subsection.

Such consent, once given, may not be rescinded except with the approval of the Secretary or his delegate.

(b) DEFINITION OF MODIFIED COINSURANCE CONTRACT.—For purposes of this section, the term "modified coinsurance contract" means an indemnity reinsurance contract under the term of which—

(1) a life insurance company (hereinafter referred to as "the reinsurer") agrees to indemnify another life insurance company (hereinafter referred to as "the reinsured") against a risk assumed by the reinsured under the insurance or annuity policy reinsured,

(2) the reinsured retains ownership of the assets in relation to the reserve on the policy reinsured,

(3) all or part of the gross investment income derived from such assets is paid by the reinsured to the reinsurer as a part of the consideration for the reinsurance of such policy, and

(4) the reinsurer is obligated for expenses incurred, and for Federal income taxes imposed, in respect of such gross investment income.

(c) SPECIAL RULES.—Under regulations prescribed by the Secretary or his delegate, in applying subsection (a)(1) with respect to any insurance or annuity policy the following rules shall (to the extent not improper under the terms of the modified coinsurance contract under which such policy is reinsured) be applied in respect of the amount of such policy reinsured:

(1) * * *:

(2) * * *;

(3) RESERVES AND ASSETS.—The reserve on the policy reinsured shall be treated as a part of the reserves of the reinsurer and not of the

reinsured, and the assets in relation to such reserve shall be treated as owned by the reinsurer and not by the reinsured.

* * *

Treasury Regulations

Treas. Reg. Sec. 1.801-3.—Definitions.—

For purposes of part I, subchapter L, chapter 1 of the Code, this section defines the following terms which are to be used in determining if a taxpayer is a life insurance company (as defined in section 801(a) and paragraph (b) of this section):

* * *

(e) *Unearned premiums.* The term "unearned premiums" means those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Such term includes all unearned premiums, whether or not required by law.

(f) *Life insurance reserves.* For the definition of the term "life insurance reserves," see section 801(b) and § 1.801-4.

* * *

(h) *Total reserves.* For the definition of the term "total reserves," see section 801(c) and § 1.801-5.

* * *

Treas. Reg. Sec. 1.801-4.—Life insurance reserves.—

(a) *Life insurance reserves defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term "life insurance reserves" (as defined in section 801(b)) means those amounts—

(1) Which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest;

(2) Which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies; and

(3) Which, except as otherwise provided by section 801(b)(2) and paragraphs (b) and (c) of this section, are required by law. For the meaning of the term "reserves required by law," see paragraph (b) of § 1.801-5. For purposes of determining life insurance reserves, only those amounts shall be taken into account which must be reserved either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute. Moreover, such amounts must actually be held by the company during the taxable year for which the reserve is claimed. However, reserves held by the company with respect to the net value or risks reinsured in other solvent companies (whether or not authorized) shall be deducted from the company's life insurance reserves. For example, if an ordinary life policy with a reserve of $100 is reinsured in another solvent company on a yearly renewable term basis, and the reserve on such yearly renewable term policy is $10 the reinsured company shall include $90 ($100 minus $10) in determining its life insurance reserves. Generally, life insurance reserves, as in the case of level premium life insurance, are held to supplement the future premium receipts when the latter, alone, are insufficient

to cover the increased risk in the later years. For examples of reserves which qualify as life insurance reserves, see paragraph (d) of this section. For examples of reserves which do not qualify as life insurance reserves, see paragraph (e) of this section.

Treas. Reg. Sec. 1.801-5.—Total reserves.—

(a) *Total reserves defined.* For purposes of section 801(a) and § 1.801-3, the term "total reserves" is defined in section 801(c) as the sum of—

(1) Life insurance reserves (as defined in section 801(b) and § 1.801-4),

(2) Unearned premiums (as defined in paragraph (e) of § 1.801-3), and unpaid losses (whether or not ascertained) (as defined in paragraph (g) of § 1.801-3), not included in life insurance reserves, and

(3) All other insurance reserves required by law. The term "total reserves" does not, however, include deficiency reserves (within the meaning of section 801(b)(4) and paragraph (e)(4) of § 1.801.-4), even though such deficiency reserves are required by State law. In determining total reserves, a company is permited to make use of the highest aggregate reserve required by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held during the taxable year for which the reserve is claimed. For example, during the taxable year 1958 a life insurance company sells life insurance and annuity contracts in States A and B. State A requires reserves of 10 against the life and 5 against the annuity business. State B requires reserves of 9 against the life and 7 against the annuity

business. Assuming the company actually holds these reserves during the taxable year 1958, its highest aggregate reserve for such taxable year is the 16 required by State B. Thus, the company is not permitted to compute its highest aggregate reserve by taking State A's requirement of 10 against its life insurance business and adding it to State B's requirement of 7 against its annuity business.

(b) *Reserves required by law defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

* * *

STATEMENT

In this Federal income tax case, petitioner seeks reversal of a judgment of the United States Court of Claims that respondent, Penn Security Life Insurance Company, was entitled to compute its income tax for the years 1963, 1964 and 1965 under Internal Revenue Code provisions applicable to life insurance companies. It is no longer disputed that respondent qualified as a life insurance company in 1965 because petitioner does not take exception to that part of the Court's decision holding that the Internal Revenue Service erroneously disallowed life insurance reserves claimed by respondent for that year.

The remaining question is whether respondent's life insurance reserves comprised more than 50 percent of its total reserves during the years 1963 and 1964. Petitioner concedes they did if one looks to the reserves actually held by respondent and accepted by the insurance authorities of the State of Missouri who regulated respondent's business. Petitioner contends, however, that it is entitled to attribute "unearned premiums" to respondent that were actually held by two unrelated companies, the Pilot and National Fidelity life insurance companies, and that this attribution prevents respondent from qualifying for life insurance company status.

Respondent's principal business during these years consisted of reinsuring companies writing credit life insurance policies covering debtors of the Aetna Finance Company, respondent's parent company.[1] (Finding 4, Pet. App. 31a). These policies sometimes included accident and health as well as life insurance coverage, but life insurance benefits accounted for more than half the dollar value of all benefits reinsured by respondent. (Finding 13, Pet. App. 36a).

Pilot and National Fidelity were two of the companies that issued credit insurance policies covering Aetna's loan customers. (Finding 7, Pet. App. 32a-33a). In separate but substantially identical accident and

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[1] Respondent could not write insurance directly on the debtors of Aetna Finance Company, which had 200 offices in approximately 25 states, because in these years respondent was only licensed to do business in the State of Missouri. (Ex. 24, A. 48, 101) By 1967, respondent's volume of business increased to the point at which it became more profitable for it to write its own credit insurance policies than to reinsure other companies. (Finding 4, Pet. App. 31a). As of December 31, 1968, respondent was authorized to transact insurance business in all states except Connecticut, New York and New Jersey. (Ex. 25, A. 48, 136-137).

health reinsurance treaties with the two companies, respondent agreed to reinsure 100 percent of their liability to pay accident and health benefits under these policies. (Finding 18, Pet. App. 40a). Pilot and National Fidelity (hereinafter sometimes referred to as the ceding companies) agreed to pay a reinsurance premium to respondent each month for accident and health reinsurance provided by respondent during the previous month, in an amount equal to 98 percent of the premiums they earned in that month under the disability provisions of their policies. (*Ibid.*)

The credit insurance sold by Pilot and National Fidelity to loan customers of Aetna was usually written for a term of two to three years, typically coextensive with the term of the debtor's loan. (Finding 5, Pet. App. 31a-32a). A separate, single premium for accident and health coverage (when provided) was charged in advance for the entire period, payable at the inception of the policy term. (Finding 8, Pet. App. 33a).

By collecting disability premiums in advance, Pilot and National Fidelity incurred contractual and statutory obligations to their policyholders to provide insurance coverage, pay claims, and refund the advance premiums if a policy was canceled or otherwise terminated prior to the end of its term. (Findings 16 and 19, Pet. App. 38a-39a, 43a-44a). Pilot and National Fidelity were required by law to set aside unearned premium reserves on these policies; *i.e.*, funds equal to that portion of premiums collected in advance from their policyholders which they would have to refund if all their policies were canceled at once. (Findings 11, 16, and 19, Pet. App. 35a, 38a-39a, 43a-44a).

The unearned premium reserves which petitioner seeks to attribute to respondent were actually held by Pilot and National Fidelity and were included in the annual statements which they filed with (and which were accepted by) the insurance authorities of the various states in which they did business. (Finding 16, Pet. App. 38a-39a). Respondent's agreement to reinsure Pilot and National Fidelity did not relieve those companies of their legal obligation to maintain unearned premium reserves on their policies covering Aetna's debtors. (Finding 19, Pet. App. 43a-44a). Pilot and National Fidelity would have been entitled to a credit under state law against their reserve liabilities had they actually transferred their reserves to respondent, but they were not required to and did not in fact do so. (Findings 16 and 19, Pet. App. 38a-39a, 43a-44a).

Respondent had no right to the unearned premium reserves which petitioner seeks to attribute from Pilot and National Fidelity. (Finding 16, Pet. App. 38a-39a). Those reserves were invested by Pilot and National Fidelity along with their other reserve funds for their own accounts. (*Ibid.*) The income from such investments belonged exclusively to Pilot and National Fidelity, not respondent. (*Ibid.*)

Respondent did not own or control Pilot or National Fidelity, nor did any of its affiliates. (*Ibid.*) At no time were the unearned premiums which petitioner seeks to attribute to respondent either credited, set apart, or otherwise made available for respondent's use. (*Ibid.*)

Since respondent did not receive premiums in advance for future insurance coverage from Pilot and National Fidelity, and held no premiums that it might be required to refund if its treaties were canceled or otherwise terminated, it was neither necessary nor ap-

propriate for respondent to maintain an unearned premium reserve under applicable state regulatory requirements and actuarial principles. (Findings 20, 21, 22 and 29, Pet. App. 44a-45a, 48a-49a).

None of the annual statements filed by respondent with the Missouri Division of Insurance reflected an unearned premium reserve liability in respect of its disability reinsurance treaties with Pilot and National Fidelity or the policies issued by those companies. (Finding 26, Pet. App. 46a-47a). If an insurance company does not properly report its liabilities on its annual statements, state insurance examiners will recompute its liabilities in accordance with actuarial standards and governing state law and regulations. (Finding 27, Pet. App. 47a). Respondent's annual statements were audited and accepted by the Missouri Division of Insurance as well as by examiners from Maryland, Wyoming, and California. (Findings 28 and 29, Pet. App. 47a-49a). No state regulatory authority would impose an unearned premium reserve requirement on an insurance company where, as under respondent's disability reinsurance treaties with Pilot and National Fidelity, such company did not receive premiums in advance for insurance to be provided in the future. (Finding 29, Pet. App. 48a-49a).

These findings are repeated in some detail because petitioner's brief frequently relies on assertions that are simply contrary to the facts found by the Court of Claims, often without acknowledging the inconsistency. The findings make abundantly clear, for example, that the role of Pilot and National Fidelity in these transactions was not merely that of a "paymaster" or banker holding funds "on behalf of" respondent. (See Pet.

Br. 31, 36-37, 50). Further, Missouri law did not require respondent to establish an unearned premium reserve as petitioner contends. (Pet. Br. 66-75). The Court of Claims stated and explained in at least four different findings that respondent was not required to maintain an unearned premium reserve under either state law or actuarial principles.

The Court of Claims' findings were made on a record of facts and exhibits that petitioner stipulated to almost in their entirety. Findings regarding state regulatory reserve requirements and actuarial principles were based principally upon the testimony of an expert witness who petitioner stipulated was "familiar with the standard valuation laws in force in all 50 states, and with the requirements and examination procedures of the National Association of Insurance Commissioners." The facts and theories petitioner now espouses were never supported by testimony or other evidence in the trial below, which of course would have made them subject to cross-examination and rebuttal by respondent. Not only are the Court of Claims' findings not "clearly erroneous"; there is *nothing* in the record to contradict them.

The Court of Claims held that including unearned premiums in respondent's reserves would be inconsistent with petioner's own Regulations since respondent did not receive reinsurance premiums "paid in advance" from Pilot and National Fidelity as required by Treas. Reg. Section 1.801-3(e). The Court rejected the attribution theory accepted by the Seventh Circuit in *Economy Finance Corp.* v. *United States*, 501 F.2d 466 (7th Cir. 1974), *cert. denied*, 420 U.S. 947 (1975), but it did not believe *Economy Finance* was decided on

"similar facts" as petitioner erroneously suggests. Because of side agreements in that case which gave the taxpayers' stockholders actual possession of the unearned premiums (including the income therefrom), the Court of Claims found the arrangement in *Economy Finance* "quite different from the one involved in the case at bar." (Pet. App. 15a-16a).

The facts of this case are also different in critical respects from *Consumer Life Insurance Co.* v. *United States*, 524 F.2d 1167 (Ct. Cl. 1975), *cert. granted*, 44 U.S.L.W. 3670 (May 25, 1976) and *First Railroad & Banking Co.* v. *United States*, 514 F.2d 675 (5th Cir. 1975), *cert. granted*, 44 U.S.L.W. 3670 (May 25, 1976), cases that have been consolidated for argument with *Penn Security*. Petitioner's brief blurs the factual differences between these cases and confuses the record in one case with that of another. It is important, therefore, that significant differences in the records of these three cases be set forth here.

1. Respondent is a reinsurer which entered into what petitioner concedes were "bona fide reinsurance agreements" with unrelated companies. (Pet. Br. 54, 74). It is not disputed that respondent never received nor actually held unearned premiums under its agreements with Pilot and National Fidelity, the ceding companies.

In *First Railroad & Banking Co.*, and in Treaty II in *Consumer Life*, direct insurers actually received unearned premiums from their policyholders. The insurers' position in these cases is that the unearned premiums were transferred to reinsurers and therefore were not includible in their reserves. Contrary to its position in *Penn Security*, petitioner contends that

these reinsurance agreements were not "bona fide". Petitioner's sweeping "reserves follow the risk" rule is wrong as a matter of law, but petitioner could still prevail under traditional "substance over form" doctrine in *First Railroad* and under Treaty II in *Consumer Life* if the facts justified its contention that those treaties were not really reinsurance agreements.

2. The Court of Claims found that respondent would qualify as a life insurance company even under a reserves follow the risk rule if attribution was limited to unearned *net* premiums representing the "cost of carrying the insurance risk" on Pilot's and National Fidelity's policies (Findings 32 and 34, Pet. App. 50a, 52a).[2] This finding, absent from both *Consumer Life* and *First Railroad,* is especially significant because Treasury regulations define "unearned premiums" as the amounts necessary to cover "the cost of carrying the insurance risk." Treas. Reg. Section 1.801-3(e).

3. More than half the dollar value of the credit insurance benefits reinsured by respondent were life insurance benefits. There was no such finding in *Consumer Life* or *First Railroad.* Since petitioner would disqualify respondent from life insurance company tax status though its actual reserves and principal business were both predominantly life insurance, this case best

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[2] For 1964, this is subject to the condition that respondent be able to include unpaid losses on credit life insurance in the numerator and denominator of the reserve test. The Court of Claims has previously indicated that this is the proper treatment for unpaid losses on credit life insurance. *See* Alinco Life Ins. Co. v. United States, 373 F.2d 336, 354 (Ct. Cl. 1967). Despite the seemingly plain language of the statute, the Internal Revenue Service takes a contrary view. *See* Rev. Rul. 72-115, 1972-1 Cum. Bull. 200.

illustrates that its "reserves follow the risk" rule is arbitrary and capricious.

4. Neither of the ceding companies was owned or controlled, directly or indirectly, by respondent or its affiliated companies. This was also true in *Consumer Life,* while the unearned premiums in *First Railroad* were held by an affiliated company. *Cf.* Section 482, Int. Rev. Code of 1954; *Superior Life Insurance Co.* v. *United States,* 462 F.2d 945 (4th Cir. 1972).

5. Petitioner introduced no evidence to support its theory, first advocated in the *en banc* rehearing below, that respondent was required by state law to establish unearned premium reserves. It did introduce such evidence in *First Railroad* and *Consumer Life,* though the evidence was disregarded in the former case and explicitly rejected in the latter.

SUMMARY OF ARGUMENT

Section 801(a) of the Internal Revenue Code provides that if an insurance company's life insurance reserves (not in dispute here) comprise more than 50 percent of its "*total reserves*", defined in Section 801 (c) as including "*unearned premiums*" and other insurance reserves *required by law*", it is to be considered a "life insurance company" for tax purposes. (Emphasis added). Respondent met this test on the basis of the reserves it actually held, computed in accordance with generally accepted actuarial principles and the reserve requirements of state law.

The issue is whether petitioner may take unearned premiums held by Pilot and National Fidelity in sat-

isfaction of *their* contractual and statutory obligations to *their* policyholders and "attribute" them to respondent in such manner that respondent's life insurance reserves no longer comprise 50 percent of the inflated "total reserves" figure produced by petitioner's attribution.

Treasury Regulations "to be used in determining if a taxpayer is a life insurance company," contain the definitions and requirements for applying the Section 801(a) reserve test. *See* Treas. Reg. Section 1.801-3. Three different sections of those Regulations prohibit petitioner from attributing "unearned premiums" to respondent as it seeks to do in this case.

First, the Regulations (Treas. Reg. Section 1.801-3 (e)) define the term "unearned premiums" as "those amounts which shall cover the cost of carrying the insurance risk *for the period for which the premiums have been paid in advance.*" (Emphasis added). Respondent never received and never had any right to receive accident and health premiums "paid in advance" for any period from Pilot, National Fidelity, or their policyholders, and so cannot be charged with "unearned premiums."

Second, every reserve included in "total reserves" must have been "actually held during the taxable year for which the reserve is claimed." Treas. Reg. Section 1.801-5(a). Respondent never held and was never required to hold unearned premium reserves with respect to its reinsurance of Pilot and National Fidelity.

Finally, if the unearned premiums are to be described as "other insurance reserves required by law," Treas. Reg. Section 1.801-5(b) states that they must

have been "reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries." Respondent did not report the "attributed" unearned premium reserves in its annual statements and state regulatory authorities never required or even suggested that it do so.

Petitioner cannot avoid the result plainly required by its own Regulations by redefining the terms of Section 801 to suit its purpose here, without even acknowledging the contrary provisions of the Regulations in its brief.[3] Regulations standing as authoritative interpretations of the Section 801 reserve test for as long as 50 years are as binding on the Government as they are on taxpayers.

The Seventh Circuit's decision to rewrite Section 801 in *Economy Finance*, a case in which the facts may have compelled attribution under the "constructive receipt" doctrine in any event, should not be followed here. One problem with that decision is that it analyzed the Congressional purpose behind the reserve test in terms of the statutory scheme created by Congress in 1959, while the reserve test was enacted under a different scheme in 1921. Another problem is that the Seventh Circuit was badly misinformed about the 1959 scheme. A final problem is that when courts

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[3] We find only a reference to the Court of Claims' reliance on the Regulations' definition of "unearned premiums" in footnote 18 on page 59 near the end of petitioner's brief. There is also a critically incomplete quotation on pages 66-67 from the Regulation defining reserves "required by law" that omits the embarrassing requirement that such reserves must be reported to and accepted by state regulatory authorities.

rewrite complicated statutes, they often create more problems than they solve.

Nothing in the legislative record indicates a Congressional intention to allow the Internal Revenue Service to disregard the decision of state regulatory authorities on reserve requirements and attribute reserves to any company that has assumed a risk. On the contrary, in 1959 Congress passed special legislation for "modified coinsurance" transactions substantially similar to the reinsurance agreements involved in this case which permits the ceding company and the reinsurer the *option* of electing reserve attribution but does not give the Government authority to require such attribution. In fact, the Internal Revenue Service has ruled that the reserve on reinsured risks in such cases is properly included in the ceding company's reserves, not the reserves of the reinsurer.

Application of the Code and regulations as written does not produce absurd results in this case, or results which one can say are clearly contrary to the legislative purpose. Petitioner's rule, on the other hand, would prevent respondent from qualifying as a life insurance company though more than half the dollar value of benefits it reinsured were life insurance benefits, more than half of the cost of insurance risks were attributable to life insurance, and more than half the reserves it held in full compliance with state law were life insurance reserves.

One reason for this strange result is that petitioner's application of its "reserves follow the risk" rule is not consistent with the rationale it urges on the Court. It argues that respondent should not exclude reserves representing "estimated policy claims" from its non-

life insurance business but attributes unearned *gross* premium reserves to respondent, including reserves for overhead expenses and profit, that are approximately three times the amount necessary to satisfy all estimated claims on the reinsured policies. Thus, petitioner is not only inconsistent but unfair; it disqualifies respondent from life insurance company status by putting its thumb on the non-life side of the scale.

The reserve test has worked so well and long that any significant change in its application should be approved by Congress. This court has deemed it a wise policy to defer to Congress to fashion rules dealing with real or imagined defects in the tax law, and that is particularly appropriate in the technical, specialized field of life insurance company taxation. If Congress wants to change to a "risk" rather than reserve comparison, it can do so in a way that would not deprive companies underwriting principally life insurance benefits of life insurance company status. Equally important, Congress can act on a prospective basis that will not upset reasonable expectations of taxpayers engendered by petitioner's own Regulations.

There is no merit in petitioner's argument that, "in substance", Pilot and National Fidelity were merely respondent's agents, holding unearned premium reserves on its behalf. The Court of Claims' findings, based on uncontradicted evidence, are to the contrary. Only Pilot and National Fidelity were liable to their policyholders; only they maintained and invested the reserve funds; only they retained the income from the reserves. The reserves were never credited, set apart, or made available to respondent.

Petitioner invokes this Court's landmark decision in *Gregory* v. *Helvering,* 293 U.S. 465 (1935), and a string of other "substance over form" tax cases. But there is an equally respectable line of decisions, also headed by *Gregory,* holding that taxpayers are not required to arrange their business affairs in a way which produces the greatest tax for the Commissioner of Internal Revenue, or accept the Commissioner's offer to produce that result for them *ex post facto.* The latter doctrine is generally preferred where, as here, the Commissioner seeks to restructure a transaction between unrelated parties into a form that would have had very different legal and economic consequences.

ARGUMENT

I. PETITIONER'S OWN REGULATIONS ARE DISPOSITIVE OF THIS CASE.

Respondent qualified as a "life insurance company" under Section 801(a) because *"its"* life insurance reserves comprised more than 50 percent of *"its"* total reserves as the terms of the statute require. In calculating its reserve test for the years in issue, respondent took into account all the reserves it actually held and reported on its annual statements to the Missouri insurance authorities, which later accepted those reserves as completely satisfying the State's regulatory reserve requirements. In this and all other respects, respondent fully complied with the definitions and requirements of the Internal Revenue Service as set forth in its Regulations.

The additional unearned premiums petitioner seeks to "attribute" to respondent were not *its* unearned premiums; it had no right to them, was not required to hold them, and in fact never held them. Respondent did not have even a theoretical liability to establish an unearned premium reserve to meet accident and health risks under Pilot's and National Fidelity's policies. The insurance industry and its state regulators regarded the liability to maintain unearned premium reserves and the funds actually held in satisfaction of that liability as properly belonging to Pilot and National Fidelity, not respondent.

The same conclusion is compelled by the Treasury Regulations promulgated for use "in determining if a taxpayer is a life insurance company." *See* Treas. Reg. Section 1.801-3. Those Regulations treat the unearned premium reserve as belonging to the company that receives premiums "paid in advance" for insurance coverage in future periods, that "actually holds" the reserve during the taxable year, and that reports the reserve on its annual statements to state insurance authorities. *See* Treas. Reg. Sections 1.801-3(e); 1.801-5(a)(3); 1.801-5(b). Pilot and National Fidelity met all of these tests; respondent met none.

Petitioner contends that attribution of reserves from a reinsured company to its reinsurer is supported by the terms of Section 801[4] but, in making that argument, petitioner defines those terms quite differently from the definitions in its own Regulations. The "reserves follow the risk" rule for which it contends,

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[4] The terms of Section 801 plainly do not authorize attribution of reserves from one insurance company to another. When Congress wanted to give the Internal Revenue Service the power of realloca-

first being advocated some 50 years after enactment of the Section 801(a) reserve test in 1921,[5] has never been included or even proposed as part of the official Regulations interpreting Section 801. It is in fact an exercise in expediency rather than interpretation, an afterthought to justify disqualification of the credit insurance companies in these cases from life insurance company status.

Treasury Regulations may not be discarded simply because they do not suit petitioner's purpose in a particular case. They are always entitled to great weight in construing the statute, *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 501 (1948); *Fawcus Machine Co.* v. *United States*, 282 U.S. 375, 378 (1931); and are binding on the Government as well as taxpayers. *See Brafman* v. *United States*, 384 F.2d 863, 866 (5th Cir. 1957); *McCord* v. *Granger*, 201 F.2d 103, 106-107 (3d Cir. 1952); *Pacific Nat'l Bank* v. *Commissioner*, 91 F.2d 103, 105 (9th Cir. 1937). "Against the Treasury's prior long-standing and consistent administrative interpretation, [petitioner's] more recent *ad hoc* contention as to how the statute should be construed cannot stand." *United States* v. *Leslie Salt Co.*, 350 U.S. 383, 396 (1956). *See also Fribourg Navigation Co.* v. *Commissioner*, 383 U.S. 272, 283 (1965); *Hanover Bank* v. *Commissioner*, 369 U.S. 672, 686 (1962); *Helvering* v. *Oregon Ins. Co.*, 311 U.S. 267 (1940); *Helvering* v. *R.J. Reynolds Tobacco Co.*, 306 U.S. 110, 114-115 (1939).

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tion, it did so expressly in Section 482 of the Code. That Section permits attribution only between related parties and it is stipulated here that Pilot and National Fidelity were not owned or controlled, directly or indirectly, by respondent.

[5] *See* Section 242 of the Revenue Act of 1921, 42 Stat. 227, 261.

A. Respondent Did Not Receive Premiums "Paid in Advance" From Pilot and National Fidelity as Required by Treas. Reg. Section 1.801-3(e).

Treas. Reg. Section 1.801-3(e) defines the term "unearned premiums" as:

> "those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been *paid in advance.*" (Emphasis added.)

Respondent is not chargeable with "unearned premiums" from Pilot and National Fidelity because it had no right to receive and did not in fact receive premiums "paid in advance" for any future period from Pilot or National Fidelity or their policyholders.[6]

Petitioner offers a new definition in which "the phrase 'unearned premiums' . . . refers to the unearned premium *reserve* that reflects an insurance company's liability to meet casualty insurance claims." (Pet. Br. 41) (emphasis in original). Arguing from this premise, petitioner contends that since respondent agreed to reinsure accident and health risks assumed by Pilot and National Fidelity, it had the "ultimate" liability to pay their insurance claims and is required to reflect that liability in its reserves.

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[6] Petitioner argues that since respondent undertook to reimburse the ceding companies for all claims paid, those companies did not bear the "cost of carrying the insurance risk" for any period (Pet. Br. 59, fn. 18.) That is irrelevant (the ceding companies' reserves are not in issue here) but also factually and legally incorrect since respondent's agreement to reinsure the ceding companies did not release them from their obligations to their policyholders. See p. 11, *supra.*

The issue actually posed by petitioner's Regulations, however, is not whether respondent agreed to reinsure risks in the future, but whether respondent was *paid in advance* for reinsuring risks in the future. The Regulations do not refer to unearned premiums as a liability to be imputed to any company which has agreed to insure or reinsure a risk. The insured or ceding company must have paid in advance for its insurance coverage in future periods or there are no "unearned premiums."[7]

Petitioner seeks only to confuse the issue by distinguishing unearned premium dollars, an asset, from the unearned premium reserve, a liability. There is no important distinction between the two because, as the popular song goes, "you can't have one without the other." Whether the Regulations refer to an asset or a liability, the Court must look to the mode of premium payment to determine whether a company has received unearned premiums for which a reserve is required. Treas. Reg. Section 1.801-3(e). *See* Findings 20, 22 (Pet. App. 44a-45a); Eilers & Crowe (ed.), *Group*

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[7] The expert witness in this case testified that "it would be impossible to have an insurance operation" if insurance companies were required to establish a liability based on premiums to be paid in the future but not yet received. A. 182. In the case of life insurance, for example, the reserve liability is based on the difference between the *present value* of future claims expected to be paid and the *present value* of premiums to be received. If this test had been applied to respondent's accident and health reinsurance treaties with the ceding companies, under any reasonable assumption as to future claims, the present value of future reinsurance premiums would have exceeded the present value of probable claims. (Finding 21, Pet. App. 44a). Thus respondent had no reserve "liability" either under the traditional unearned premium reserve method or the future risk approach that petitioner advocates here.

Insurance Handbook 1965 8 Mertens, *Law of Federal Income Taxation* (1970 revision), § 44.28.[8]

The Regulations' requirement that unearned premiums be "paid in advance" is taken (along with the rest of the definition of "unearned premiums") from a House Ways and Means Committee Report. *See* H.R. Rep. No. 2333, 77th Cong., 2d Sess. (1942), 109, quoted at pp. 43-44, *infra*. This is far stronger evidence of the Congressional understanding of "unearned premiums" than anything petitioner has been able to muster in support of its "reserves follows the risk" rule.

The "paid in advance" requirement is an indispensable element of the definition of "unearned pre-

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[8] Petitioner conceded below that unearned premiums held by another company reinsured by respondent, Old Republic Life Insurance Company, could not be attributed to respondent under Section 801. The terms of the Old Republic disability reinsurance treaty were substantially identical to the Pilot and National Fidelity treaties, including the monthly earned premium mode of payment. Unlike the Pilot and National Fidelity treaties, however, there was no "run-off provision" in the Old Republic treaty which obligated respondent, in the event of cancellation of the treaty, to continue the treaty in force with respect to any policies issued by the reinsured companies prior to the date of cancellation. The presence of a run-off provision in the Pilot and National Fidelity treaties might have significance if unearned premium reserves were really calculated solely on the basis of the liability an insurance company agrees to assume in the future, but that is not the way either the Regulations or the insurance industry defines the term. The expert in this case commented specifically on the irrelevance of a run-off provision in computing an unearned premium reserve, concluding that:

> "[Under] all of these treaties [that is, Old Republic, Pilot and National Fidelity], *even though they differ in the run-off provision*, the premium payments received by [respondent] were after the expiration of the period of coverage for which the premium was paid, and, therefore, . . . there could be no unearned premium reserve." A. 181. (Emphasis added.)

miums" because the unearned premium reserve has always been understood as the measure of a company's potential obligation to refund premiums not yet earned if all its policies were suddenly and prematurely cancelled. (Finding 11, Pet. App. 35a). Indeed, unearned premiums are more an accounting than an insurance concept; a recognition of services paid for but not yet provided. *See* National Association of Insurance Commissioners, *Examiners' Handbook* (1970 ed.), App. B, p. B13:

> "The basic reason [for an unearned premium reserve] is simply that it is proper accounting practice to establish a liability for *income received but not yet earned.*" (Emphasis added).[9]

Respondent never received a prepayment of premiums from Pilot and National Fidelity which it could be required to refund, nor was it liable for refunds to their policyholders. Hence, there was no need for respondent to establish an unearned premium reserve as that term has traditionally been understood in the insurance industry.

B. Respondent Did Not "Actually Hold" Unearned Premium Reserves in Respect of its Treaties with Pilot and National Fidelity as Required by Treas. Reg. Section 1.801-5(a).

Petitioner's new definition of "unearned premiums" requires the Court to accept the novel proposition that a "reserve" for purposes of Section 801 means or includes a theoretical reserve liability for which the

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[9] Similarly, a landlord who rents a building for stipulated monthly rentals over a three-year period does not establish a liability merely because he is obligated to furnish the premises to the tenant over that period, but he would record any advance rentals as "unearned" or "prepaid" rent, until they were earned.

insurance company has not actually set aside any of its own funds. The suggestion that respondent ever had any such liability under its reinsurance agreements with Pilot and National Fidelity is contrary to the findings of the Court of Claims and the uncontradicted facts of record. See pp. 31-36, *infra*. But even if respondent had a liability for which it concededly set aside no funds, that would not constitute a "reserve" for purposes of Section 801.

This Court recognized long ago in *Maryland Casualty Co.* v. *United States*, 251 U.S. 342 (1920), that the term "reserve" has a special meaning in the law of insurance, that in general it means "a *sum of money*" which is *set aside*, "*reserved*," as a *fund*. 251 U.S. at 350[10] (emphasis added). Since 1922 the Treasury's regulations have provided that while "a company is permitted to make use of the highest aggregate reserve called for by any State in which it transacts business, . . . the reserve must have been *actually held* as shown by the annual statement." See Regulations 62, Art. 681 (1922 ed.) (emphasis added).

The Treasury's Regulations still provide today that "in determining total reserves, a company is permitted to make use of the highest aggregate reserve required by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been *actually held* during the taxable year for which the reserve is claimed." Treas. Reg. Section 1.801-5(a)(3). (Emphasis added.) The unam-

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[10] Until the Revenue Act of 1942, a life insurance company was actually defined in terms of the "reserve *funds*" it held. *See, e.g.*, Section 242 of the Revenue Act of 1921, 42 Stat. 227; *cf.* Section 801(b), Int. Rev. Code of 1954.

biguous requirements of this long-standing Regulation leave no place for an unfunded "reserve liability" that is not actually set aside out of the premiums received by the insurance company.

Aside from confirming that the term "reserve" means a sum of money, the "actually held" requirement serves a salutary purpose in the administration of the income tax law. Without it, a company could claim life insurance reserves for tax purposes based on the most conservative mortality tables and interest assumptions allowed by state law, while actually keeping a lower reserve based on more reasonable assumptions in its own business. Or a company could compute a deduction for the increase in its unearned premium reserves during the year by calculating unearned premiums on a pro-rata basis for tax purposes while actually maintaining lower unearned premiums under the "Rule of 78."[11] If the Treasury really means to abandon its "actually held" requirement, it should look to all the consequences.

These Regulations also evidence a longstanding Treasury policy that Federal income tax authorities should not become enmeshed in technical determinations as to the amount or sufficiency of state regulatory reserve requirements. See *Lamana-Panno-Fallo Industrial Ins. Co.* v. *Commissioner,* 127 F.2d 56, 58-59 (5th Cir. 1942), where the court said:

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[11] The Rule of 78 is like the "sum of the years digits" method of computing depreciation. See Treas. Reg. Section 1.167(b)-3. For example, if an insurance company receives a $360 premium for three years' insurance coverage, the unearned premium at the end of the first year would be $240 under a pro-rata method (⅔ times $360), but only $180 under the Rule of 78 (2 plus 1 divided by 3 plus 2 plus 1 times $360). See Finding 10, Pet. App. 34a-35a.

> "It is not the function of the Commissioner to review the decision of the State insurance department as to the sufficiency of the reserves or the solvency of the company. There is no federal policy to tax discriminatorily a life insurance company whose reserves may be deficient or depleted .... [The predecessor of Treas. Reg. Section 1.801-5(a)(3)] . . . provides that 'a company is permitted to make use of the highest aggregate reserve called for by any State * * * in which it transacts business, but the reserve must have been actually held.' We find no provision in Statute or Regulation looking to a demand on the Commissioner's part for larger reserves that [sic] the State has required."

See also *Alinco Life Ins. Co.* v. *United States,* 373 F.2d 336, 345 (Ct. Cl. 1967).[12]

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[12] Whether or not unearned premiums must be required by law (see Pet. Br. p. 60, fn. 19), petitioner is not free to disregard the decision of State regulatory authorities that reserves are not required. *Cf.* Maryland Casualty Co. v. United States, 251 U.S. 342, 349 (1920); Commissioner v. Idaho Power Co., 418 U.S. 1, 14-15 (1974); Commissioner v. Lincoln Savings & Loan Assn., 403 U.S. 345, 355-356 (1971). This Court's prior decisions on reserve issues, cited by petitioner in its footnote 19, merely distinguish technical insurance reserves from solvency reserves and do not suggest that the Court is prepared to substitute its judgment on actuarial matters and state regulatory requirements for that of the actuaries and state authorities charged with the interpretation and execution of insurance laws. There is only one case of which we are aware in which unearned premiums were included in the reserve test even though supposedly not required by law, *see* National Protective Ins. Co. v. Commissioner, 128 F.2d 948 (8th Cir. 1942), but even there the unearned premiums were actually held by the company charged with them and were held, moreover, pursuant to a written agreement with the State Superintendent of Insurance and carried as a liability by the taxpayer in its annual statements.

C. The Unearned Premiums Attributed to Respondent Were Neither Reported by Respondent on Its Annual Statements Nor Accepted by State Regulatory Officials of Missouri as Required by Treas. Reg. Section 1.801-5(b).

Before, during and after the trial of this case, and on its appeal from the trial judge's decision to a three-judge panel of the Court of Claims, petitioner took the position that it was "irrelevant to tax treatment" that the State of Missouri did not require respondent to maintain unearned premium reserves under its reinsurance treaties with Pilot and National Fidelity.[13] Then, as explained by the Court of Claims in its opinion below (Pet. App. 21a):

> "At a later stage in this litigation the court itself injected an issue which had not been presented to the trial judge or to the three-judge panel of the court which first heard the argument. As a result of the decision by a different trial judge in *Consumer Life Ins. Co.* v. *United States,* No. 463-70, the court ordered the parties to brief and argue the question of whether *state law* required the taxpayer to establish an insurance reserve for the unearned premiums involved here. (If so, the case would be governed by Section 801(c)(3), . . . and the taxpayer would lose.) The case was then ordered to be heard *en banc.*[3]

"[3] This was done before the three-judge panel had rendered its decision."

In its *en banc* decision, the Court of Claims held that respondent was not required by Missouri law to main-

[13] *See, e.g.,* Defendant's Submission in Response to Pre-Trial Order Under Rule 111, p. 25; Brief for the United States to Commissioner Fletcher, p. 27; Brief and Exceptions for the United States, pp. 6, 17; Reply Brief for the United States, p. 3.

tain unearned premium reserves, basing its conclusion on findings made by the trial judge on uncontradicted evidence and noting that the text of the Missouri statutes relied upon by petitioner "fully harmonizes with the interpretation of Missouri law spelled out in our findings and followed by the Missouri insurance administrators, *i.e.*, that Missouri law did not during the years in question require this taxpayer to set up the reserves in question."

Petitioner's attempt to raise the issue anew cannot be sustained on the record of this case. Petitioner stipulated that respondent maintained no unearned premium reserves with respect to its reinsurance of Pilot and National Fidelity and reported no such reserves on its annual statements to the insurance authorities of Missouri (Finding 16, 26, Pet. App. 38a-39a, 46a-47a); that the Missouri Division of Insurance twice audited respondent for the period in which these reinsurance treaties were in force (Finding 28, Pet. App. 47a-48a); and that the Missouri Division of Insurance did not require respondent to establish unearned premium reserves (Finding 29, Pet. App. 48a-49a).

Furthermore, the expert witness in this case testified that no state regulatory authority would impose an unearned premium reserve requirement on an insurance company where, as under respondent's disability reinsurance treaties with the ceding companies, such company did not receive premiums in advance for insurance to be provided in the future. (Finding 29, *supra.*) With respect to this testimony, petitioner stipulated that the expert was "familiar with the standard valuation laws in force in all 50 states, and with the requirements and examination procedures of the National Association of Insurance Commissioners."

These facts *compel* a finding that respondent is not chargeable with a "reserve required by law" within the meaning of Section 801(c)(3). Though once again petitioner chooses not to acknowledge its own Regulations, the definition of "reserves required by law" prescribed therein requires that the reserve be "reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries." Treas. Reg. Section 1.801-5(b). Those requirements plainly were not met here.

The language of the Regulations mocks petitioner's argument that "the state insurance officials' failure to require the taxpayers to establish A&H reserves can hardly be dispositive of the question whether those reserves were 'required by [state] law' under Section 801(c)(3)." (Pet. Br. 67). The principles of *Commissioner* v. *Estate of Bosch,* 387 U.S. 456 (1967), can hardly be applicable when acceptance of the reserve by state regulatory authorities is given controlling weight by petitioner's own Regulations. Further, this Court long ago rejected the idea that the reserve requirements of state regulatory authorities may be disregarded in determining when reserves are "required by law." *Maryland Casualty Co.* v. *United States,* 251 U.S. 342, 349 (1920). Finally, the highest court of Missouri has spoken on the question of whether the laws of that state contemplate a reserve for premiums that have not been collected.

> "[U]ncollected premiums [may] not be counted as part of the [unearned premium] reserve, for the latter must always be available." *State ex rel. American Central Insurance Co.* v. *Gehner,* 320 Mo. 901, 9 S.W.2d 621, 624 (1928).

In "proving" that respondent was required by Missouri law to maintain unearned premium reserves, petitioner's principal reliance is not on the record in this case, where it chose not to introduce any evidence, but on testimony of insurance examiners from states other than Missouri, which was received in unrelated cases, where it was rejected in *Consumer Life* and apparently disregarded in *First Railroad* (where the issue was entirely different in any event). In none of those cases did the insurance authorities actually attribute reserves under a "reserves follow the risk" principle. The expert in this case testified that he never heard of any state that has ever done so.[14] Even the Seventh Circuit in *Economy Finance* conceded that reinsurers paid on a monthly earned premium basis "could not establish an unearned premium reserve, because the premiums were not received until they were fully earned." *See Economy Finance Corp.* v. *United States,* 501 F.2d at 471.

Petitioner's contentions regarding Missouri law are discussed in the footnote below.[15] Particularly in view

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[14] A. 188.

[15] Petitioner's citation of Section 376.410(4) of the Missouri statute (Pet. Br. 73), providing that "proper credit shall be allowed for reinsurance in other companies licensed to do business in this state," deals only with the reserve requirements of ceding companies and does not authorize attribution to a reinsurer of a reserve it does not hold. The expert witness in this case explained that such provisions allow credit for reinsurance only where the reserve is actually transferred to the reinsurer, and not otherwise. (Finding 19, Pet. App. 43a-44a.)

Section 375.246 of the Missouri statute, cited by petitioner in its footnote 20 (Pet. Br. 73), gives the Missouri Director of Insurance authority to disallow a credit if he finds that the reinsurance transaction has been arranged "for the purpose principally of deception as to the ceding company's financial condition," including the type

of its Regulations, it seems more than a little presumptuous of petitioner to suggest that a tax lawyer's analysis of the insurance laws of Missouri should be regarded as authoritative as against the contrary interpretation of the state regulatory officials entrusted with the execution of those laws and the uncontradicted testimony of an expert familiar with the insurance laws of all 50 states.

There is no rationale consistent with the statute, Regulations and past decisions of this Court for accepting petitioner's contention that the unearned premiums it seeks to attribute to respondent were "required by law" despite the fact that the Missouri Insurance Department never required them. Should this Court disagree, however, it seems only fair, in view of the late stage at which the issue was raised, and the fact that respondent was misled by petitioner's

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of arrangement described in petitioner's footnote. There was no reason for the expert to consider that provision in this case when petitioner has conceded that these reinsurance agreements were bona fide. Further, that provision was enacted in 1967, after the years in issue in this case.

Presumably petitioner does not offer the Hammond treatise cited in footnote 27 (Pet. Br. 72) as an authoritative exposition of Missouri law. The accounting treatment prescribed therein is concerned with cases in which the reinsurer has some contractual right in funds "deposited with" the ceding company. It is stipulated in this case that Pilot and National Fidelity did not credit, set apart, or make the unearned premium reserves available to respondent, and indeed invested and received the income from those reserve funds for their own account. Compare Thompson, *Reinsurance* (4th ed. 1966), at p. 174: "If the excess premium is to be paid on a quarterly basis, that is of course each three months, as a rule there is no deposit premium paid. The ceding company merely reports the net premiums quarterly and pays accordingly. Then the excess reinsurance premiums are earned when paid and do not enter into the premium reserve."

previous position that it considered state law "irrelevant" to the issues, that the case be remanded to give respondent the opportunity of introducing further evidence on the insurance reserve requirements of Missouri.[16]

II. THE STATUTE AND REGULATIONS DEFINE A LIFE INSURANCE COMPANY IN TERMS OF RESERVES HELD, NOT RISKS ASSUMED.

A. It Was Not the Purpose of Congress To Go Beyond the Reserves Actually Held by a Company to Determine the Nature of Its Business.

While petitioner now insists that the statutory language of Section 801 supports an attribution rule, the Seventh Circuit in *Economy Finance* was candid enough to admit that attribution could not be supported by "a literal interpretation of § 801(a) . . ." See *Economy Finance Corp.* v. *United States,* 501 F.2d 466, 477. Moreover, there is no evidence in the meager amount of legislative materials available[17] that Con-

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[16] During the discovery stage of this litigation, counsel for petitioner and respondent agreed upon a list of questions to be put to officials of the Missouri Division of Insurance and the Government's expert in the Department of Insurance of the State of Illinois. Those officials responded categorically that they would not require respondent to maintain an unearned premium reserve under its treaties with the ceding companies and that their departments had never attributed reserves to a reinsurer under monthly earned premium treaties. That is why petitioner lost interest in the state law issue and regarded it as "irrelevant" until the rehearing *en banc* below.

[17] The Committee reports on Section 242 of the Revenue Act of 1921, the first predecessor of Section 801(a), do not even mention the reserve test. *See* H.R. Rep. No. 350, 67th Cong., 1st Sess. (1921), 14; S. Rep. No. 275, 67th Cong., 1st Sess. (1921), 20.

gress intended the Internal Revenue Service or the courts to disregard the language of the statute and look beyond reserves actually held by insurance companies in accordance with state law and actuarial principles or to independently "scrutinize" the insurance company's business "in order to determine the source and significance of the resulting distortion when the reserve qualification formula is literally applied." *Ibid.*

We agree that "Congress employed the reserves concept as the proper measure of the amount and character of a company's insurance business for purposes of determining its tax status." (Pet. Br. 47).[18] That does not justify a "reserves follow the risk" rule however. What petitioner proposes is not a test "measured by *their* reserves," as Dr. Adams of the Treasury Department testified in 1921 (Pet. Br. 46), but a test looking to risks which the company has agreed to insure against in the future, *whether or not* it holds or needs to hold reserves against those risks.

The Seventh Circuit in *Economy Finance* cited no legislative materials to support attribution, but relied on its analysis of the present scheme for taxing life insurance companies as enacted by Congress in the Life Insurance Company Income Tax Act of 1959, 73 Stat. 112.

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[18] Petitioner so construes the testimony of Dr. T. S. Adams before an executive session of the Senate Finance Committee holding hearings on the Revenue Act of 1921. Petitioner errs, however, in going further and urging that the testimony of that Treasury official be taken as authority for the proposition that an unfunded liability based on risks assumed should be included in the reserve test, when the Treasury's official interpretation of that Act from 1922 to the present time has been that only reserves "actually held" may be claimed in the reserve ratio. See pp. 27-30, *supra*.

> "By defining life insurance companies in terms of the reserves they held, Congress identified the fund which represents, *inter alia,* nonexcess risk. Ignoring for our purpose the fact that H & A reserves also include loading,[19] Congress compared the actuarial estimate of the amount necessary to cover life contract obligations with the amount necessary to cover H & A obligations. By identifying the holders of nonexcess risk it would also identify the holder of excess risk and presumably there is a correspondence between the stated amount of nonexcess and excess risk exposure. Hence the larger the amount of nonexcess risk, the larger the excess risk exposure. For life insurance it is the existence of excess risk not currently ascertainable which mandates the deferral of 50 percent of gain from operations." *Economy Finance Corp.* v. *United States,* 501 F.2d at 477.

The argument that the reserve must follow the "excess risk" to effectuate the Congressional purpose for deferral overlooks the fact that there was no deferral when the reserve test was enacted in 1921.[20] Gain from operations was not taxed at all under the different statutory scheme which existed at that time. This

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[19] We will return later to the Seventh Circuit's cavalier dismissal of the crucial loading factor. See pp. 42-44, *infra.*

[20] The Court of Appeals was also misinformed by the Government about the extent of the deferral allowed to life insurance companies under the 1959 Act. The Government argued that deferral could be terminated "only when and if the [life insurance] company takes appropriate actions by distributing the tax-deferred amounts to its shareholders. *See* Economy Finance Corp. v. United States, 501 F.2d at 476. In fact, Congress prescribed statutory rules which limit the amount that can be deferred by a life insurance company, depending not upon its own voluntary actions but upon the amount of its life insurance reserves or premium receipts for the year. *See* Section 815(d)(4), Int. Rev. Code of 1954.

exemption was not due to an "excess risk" theory but to Congress' belief that the premium receipts of life insurance companies "were not true income but were analogous to permanent capital investment." *Helvering* v. *Oregon Life Ins. Co.*, 311 U.S. at 269.

Whatever one may think of the Seventh Circuit's argument, the following observation seems apt: "the plain, obvious meaning of the statute is always to be preferred to any curious, narrow, hidden sense that only the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover." *Old Colony Railroad Co.* v. *Commissioner*, 284 U.S. 552, 560 (1932); *Lynch* v. *Alworth-Stephens Co.*, 267 U.S. 364, 370 (1925).

B. Mandatory Attribution Is Inconsistent With the Optional Attribution Rules Prescribed by Congress in Section 820, and With the Internal Revenue Service's Position in Rev. Rul. 70-508.

If analysis of the 1959 Act suggests any legislative purpose regarding reserve attribution, it is that Congress did *not* contemplate mandatory attribution of reserves under a "reserves follow the risk" principle.

The Seventh Circuit did not come to that conclusion because its analysis completely missed Section 820 of the Code, added by the Life Insurance Company Income Tax Act of 1959, 73 Stat. 112, 137, in which Congress prescribed an *optional* reserve attribution rule for reinsurance agreements substantially similar to those in the case at bar. In these transactions, called "modified coinsurance," "the reinsurer accepts all of the obligations it would assume under a conventional coinsurance policy, but the initial insurer retains the reserves and administers the investment of the reserve

funds. However, [unlike the instant case], the initial insurer pays over the gross investment income, less additions to reserves, to the insurer." *See* S. Rep. No. 291, 86th Cong., 2d Sess. (1959) 38-39.

Attribution under petitioner's proposed rule would be inconsistent with the fact that Congress did not give the Commissioner of Internal Revenue power to require attribution in the modified coinsurance transaction. Indeed, by failing to consider Section 820, the Seventh Circuit unintentionally introduced an anomaly into the statute: under its decision, a reinsurer may successfully avoid reserve attribution if the ceding company pays it the gross investment income from the reserve in a modified coinsurance transaction, but may not resist attribution when the ceding company not only holds the reserve but keeps the investment income.[21]

It is also impossible to square petitioner's position in this case with the Internal Revenue Service's holding in Rev. Rul. 70-508, 1970-2 Cum. Bull. 136. In that

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[21] Petitioner argued below that Section 820 had no bearing on this issue because the optional attribution rule prescribed therein does not apply "for purposes of section 801". *See* Section 820(a), Int. Rev. Code of 1954. But this exception can only mean that Congress understood that the ceding company would be entitled to claim the reserve for purposes of Section 801 even though the parties had elected attribution to the reinsurer for other purposes. There would have been no reason for Congress to exclude Section 801 from the effect of reserve attribution under Section 820 had it believed that the reserve was attributable to the reinsurer for the purposes of Section 801 anyway under the "reserves follow the risk" rule. Further, the Internal Revenue Service has ruled that where the optional attribution rules of Section 820 are not elected, the reserve remains with the ceding company for purposes of Section 801 and is not attributed to the reinsurer under a reserves follow the risk rule. *See* Rev. Rul. 70-508, 1970-2 Cum. Bull. 136, discussed in the text following this footnote.

ruling, the Internal Revenue Service held that the ceding company under a modified coinsurance agreement was entitled to claim the life insurance reserves it held on reinsured risks for purposes of Section 801(b) of the Code. This was a stronger case for attribution than the present one because the ceding company paid over the investment income from the reserve to the reinsurer. Furthermore, the Regulation which defines "life insurance reserves" contains a provision (not found in any of the Regulations applicable to this case) which seemingly supports a reserves follows the risk rule. In Treas. Reg. Section 1.801-4(a), defining "life insurance reserves", the Regulations state:

> "[R]eserves held by the company with respect to the net value of risks reinsured in other solvent companies (whether or not authorized) shall be deducted from the company's life insurance reserves."

Even with this authority, the Service did not require attribution to the reinsurer or disallow the reserve in the ceding company's hands. It held that these Regulations merely prevent both the ceding company and the reinsurer from maintaining reserves on the same risk. So long as the ceding company actually holds the reserve, and the reinsurer does not, the ceding company may properly claim the reserve under Section 801(b) of the Code.[22]

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[22] Petitioner argued below that the ceding company in Rev. Rul. 70-508 was assumed to have already qualified as a life insurance company, and that the ruling was concerned only with the ceding company's ability to claim the reserve for purposes of taxation and not for purposes of qualification under Section 801. The distinction is spurious. The ruling held that the ceding company was entitled

C. Petitioner Misapplied Its Reserves Follow the Risk Rule by Attributing Gross Rather Than Unearned Net Premiums to Respondent.

Nothing better illustrates the faulty premise of the "reserves follow the *risk*" rule than the insistence of the Seventh Circuit and petitioner upon attributing the entire unearned *gross* premium reserve which includes substantial amounts of unearned "loading" charges that have nothing whatever to do with accident and health *risks*. Loading charges are not held to pay insurance claims but represent amounts charged to policyholders for commissions, overhead and profit. Finding 30, Pet. App. 49a. Unearned loading charges are reserved by the issuing company because it has an obligation to refund them in the event of premature cancellation of the policies. But a reinsurer who never receives premiums paid in advance has no such obligation.

To the extent that the unearned gross premium reserve exceeds unearned *net* premiums, *i.e.*, that part of the reserve which represents the actuarially computed morbidity cost of carrying the accident and health risks, it "is not a true insurance reserve at all, but rather a solvency reserve . . ." Finding 32, Pet. App. 50a. It is of crucial significance in this case that life insurance reserves, with which unearned premiums are compared in the Section 801 reserve test, are calcu-

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to claim a "life insurance reserve" for purposes of Section 801(b). That section applies for purposes of all the sections of the Code dealing with life insurance companies, including the Section 801(a) reserve test. See Section 801(b), Int. Rev. Code of 1954. *See also* Treas. Reg. Section 1.801-3 and Treas. Reg. Section 1.801-4(a) (to which Treas. Reg. Section 1.801-3(f) refers) which confirm that the term "life insurance reserves" as defined in Section 801(b) applies for purposes both of defining and taxing life insurance companies.

lated solely on an actuarially computed *net* premium (risk only) basis. Thus, the reserve test is meaningless unless life insurance reserves are compared with unearned *net* premium reserves on accident and health risks, excluding loading. (See Finding 36, Pet. App. 55a).

Treas. Reg. Section 1.801-3(e) supports that view. Its definition of "unearned premiums" includes only "those amounts *which shall cover the cost of carrying the insurance risk* for the period for which the premiums have been paid in advance." (Emphasis added). The Court of Claims and the Court of Appeals for the Fifth Circuit have concluded that the phrase "cost of carrying insurance risk" as used in the Regulation refers only to the unearned *net* premiums, excluding "loading." *See Alinco Life Insurance Co.* v. *United States,* 373 F.2d 336, 352 (Ct. Cl. 1967); *Great Commonwealth Life Insurance Co.* v. *United States,* 491 F.2d 109, 113 (5th Cir. 1974). *Contra: Economy Finance Corp.* v. *United States,* 501 F.2d at 482-483; *Superior Life Ins. Co.* v. *United States,* 462 F.2d at 951.

That approach is also supported by the legislative history. The paragraph in the House Ways and Means Committee report from which Treas. Reg. Section 1.801-3(e) takes its definition refers to the "cost of carrying" a risk not only in defining the term "unearned premiums" but on two other occasions where the phrase is unmistakably used in an actuarial (net premium) sense.

> "The pro rata unearned premiums are the amounts which will cover the *cost of carrying the insurance risk* for the period for which the premium has been paid in advance. The life insurance reserves . . . as they pertain to noncancellable

> health and accident insurance policies are those amounts that must be reserved, in addition to pro rate unearned premiums, to provide for the additional *cost of carrying* such policies in later years when the insured will be older and subject to greater risk and when the *cost of carrying* the risk will be greater than the premiums then being received." H.R. Rep. No. 2333, 77th Cong., 2d Sess. (1942), 109. (Emphasis added).

Petitioner conceded below that "the second and third uses of the word 'cost' in the Committee report when referring to the additional cost for carrying risks in later years, refers only to morbidity [actuarial] costs. . . ." See Reply Brief for the United States in *Penn Security Life Insurance Company* v. *United States,* p. 14. It is unlikely that the Ways and Means Committee would have employed the same phrase in the same context three times in the same paragraph and not have intended the same meaning.

Whatever the "cost of carrying the insurance risk" may mean in other contexts, moreover, petitioner cannot logically compel attribution of "loading" under the pretense of obtaining the measure of an insurance company's estimated liability to pay claims on non-life insurance risks Having anchored its argument for a "reserves follow the risk" rule on repeated assertions that an unearned premium reserve "reflects an insurance company's liability to meet casualty insurance claims," (Pet. Br. 41) [23] petitioner clearly may not

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[23] *See also* Pet. Br. 31 ("the purpose of an insurance reserve is to meet claims under the policies"), Pet. Br. 32 ("the unearned premium reserve represents the potential liability to the policyholder"), Pet. Br. 40 ("an unearned premium reserve represents the measure of the liability of an insurance company to meet claims for short-term casualty coverage"), Pet. Br. 47 ("the function of insurance reserves is to provide a fund to meet future policyholder claims"), Pet. Br. 50 ("the function of an insurance reserve is to represent the insurer's estimated liability to the policyholders").

attribute solvency reserves that are not needed to meet casualty insurance claims under that rule.[24]

D. If There Is To Be Any Modification in the Section 801 Reserve Test, It Should Be Made by Congress on a Prospective Basis.

Part I, Subchapter L, Chapter 1 of the Internal Revenue Code, dealing with life insurance companies, is a carefully wrought, interrelated set of provisions defining a scheme of taxation that is unique to that industry. Congress created a whole new tax lexicon for life insurance companies, and throughout these

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[24] Should this Court decide that petitioner has the power to reallocate reserves, but may attribute only the net (risk) premium portion allocable to the cost of carrying the insurance risk (*i.e.*, the cost of meeting casualty insurance claims), respondent's life insurance company status will not be affected. Finding 34, Pet. App. 52a.

Contrary to the assertion made on page 48, fn. 11 of petitioner's brief, respondent has also consistently maintained at all stages of this litigation that unearned premiums held under the credit life insurance policies issued by Pilot and National Fidelity qualified as unearned premiums on "noncancellable life, health or accident policies" includible in the numerator as well as the denominator of the 50 percent test. Section 801(a)(2). *See* Alinco Life Ins. Co., v. United States, 373 F.2d at 354. In Helvering v. Oregon Ins. Co., 311 U.S. at 270-71, this Court said: "It seems clear that Congress intended to permit the deduction of reserves based on those policies that make a company a 'life insurance company' under the Act, which, by definition, includes policies of 'combined life, health and accident insurance' . . . . Here, in the combined life and health and accident policies, the health and accident reserves are based upon contingencies of commencement and continuance of disability. They have a direct and inseparable relationship to the very insurance contracts which bring [the taxpayer] under a special tax scheme." *See also* Finding 35, Pet. Br. 53a, stating that Pilot's and National Fidelity's credit life insurance policies were conceptually identical to combined life and accident and health insurance contracts issued by insurance companies since the early part of this century.

sections one finds unfamiliar technical terms that only a member of the industry would understand. Accountants and lawyers do not suffice to complete a life insurance company's tax return; an actuary is essential.[25]

In this case, the Court is called upon to redefine terms and concepts that are basic to the entire statutory scheme and already have well established meanings in the insurance industry. A holding that the "reserves" of an insurance company include unfunded liabilities would create ripple effects throughout Subchapter L. The peculiar construction petitioner urges for "unearned premiums" in Section 801 of the Code, the basic definitional provision for the life insurance company sections, would be applicable at least for purposes of all of "part I, subchapter L, chapter 1 of the Code," the life insurance company provisions. Treas. Reg. Section 1.801-3.

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[25] "It is well established that the technical provisions of Section 801 (and its predecessors) were couched by Congress in language peculiar to the insurance industry and therefore intended to have the meaning generally attributed thereto by the experts." *Alinco Life Ins. Co.* v. *United States*, 373 F.2d at 352, citing 8 Mertens, Law of Federal Income Taxation (1970 revision) § 44.15, in particular footnote 11. The Mertens treatise quotes Dr. T. S. Adams, a former tax advisor to the Treasury, who testified before the Senate Finance Committee on the phraseology of the provisions in the Revenue Act of 1921 which first defined and specially taxed life insurance companies (Senate Finance Committee Hearings on H.R. 8245, 67th Cong., 1st Sess. (1921), at 87, 92):

> "Only experts are interested . . . that language merely repeats the language of the present law, language which the companies themselves proposed and which they understand . . . Every word of the phraseology of that section has been gone over by insurance experts of the very highest caliber. Only a few people are involved. The public is not interested in this, they do not have to read it, and the people who deal with it are experts. Every word of that phraseology was presented to the insurance officials, and only those companies who are involved must understand it."

The consequences to this complex scheme of rewriting Section 801 may be "opaque," but they are bound to be significant, perhaps in ways that cannot now be anticipated. *See* Pet. App. 18a. *See also Economy Finance Corp.* v. *United States,* 501 F.2d at 485-86 (dissenting opinion). Some of the questions and problems which immediately appear are the following:

—Will attribution be required if the parties do not put a "run-off" provision in their reinsurance agreement (see fn. 8, p. 26, *supra*)? If so, can the rule be efficacious if it is so easily avoided? If not, how can petitioner justify attributing a long-term liability to a company that can cancel its liability at any time?

—Does the rule apply where reinsurance is not involved? For example, it is not uncommon for insurance companies to issue policies to individuals on the same "earned premium" mode of payment used in respondent's reinsurance agreements with Pilot and National Fidelity.[26] If petitioner is correct in contending that a reserve liability arises from a mere agreement to insure in the future, whether or not premiums have been collected in advance for such insurance, will not direct insurers as well as reinsurers have "unearned premiums" attributed to them? *But see*

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[26] The Hammond treatise cited by petitioner (Pet. Br. pp. 40, 72), notes that "in certain types of insurance contracts, particularly in large group accident and health policies, the premium is not paid by the policyholder to the insurance company until after the premium is earned. In premium transactions of this type unearned premiums are not involved". Hammond, *Insurance Accounting, Fire and Casualty* (2d ed. 1965), 177. The expert witness in this case testified to the same effect. A. 189-190.

Great Commonwealth Life Ins. Co. v. *United States,* 491 F.2d 109, 113 (5th Cir. 1974) (premiums as yet unpaid by policyholders cannot be "unearned premiums"). Or will attribution in such cases depend upon whether the policyholder has cash in his bank account equal to the amount of premiums he has agreed to pay the insurance company in the future?

—What is the proper amount to be "attributed" to a company that has assumed a risk? Petitioner assumes that the reserve attributable to the reinsurer should be the same as the reserve in the hands of the ceding company. Obviously, that measure of liability will not be available in the case of a direct insurer issuing policies on an earned premium basis. Furthermore, since the Code normally gives wide latitude to the individual insurance company to determine the amount of its reserve liabilities, why should a reinsurer not be entitled to select its own actuarial assumptions regarding its "attributed" liability to pay estimated future claims on reinsured policies?

—If the Internal Revenue Service is permitted to attribute unearned premiums held on reinsured policies to the reinsurer, should not a reinsurer be permitted to similarly claim life insurance reserves held by a ceding company on reinsured risks, whether or not the ceding company has agreed to (or is able to) elect attribution under Section 820? *But see* Rev. Rul. 70-508, 1970-2 Cum. Bull. 136. Or will petitioner argue in future cases that life insurance reserves cannot be attributed because the reinsurer failed to report them on its

annual statements and they were not otherwise "required by law" within the meaning of its Regulations?[27]

—Will companies be permitted to claim deductions based upon hypothetical reserves attributed under the reserves follow the risk rule? *See* Treas. Reg. Section 1.801-3, which suggests that they must be permitted to do so. Note that this results in deductions against the real income of a life insurance company for hypothetical reserves which the company will never set aside out of income for the payment of policyholders' claims. *See, e.g.,* Sections 805, 809(a)(2), 809(d)(2), 810(c), Int. Rev. Code of 1954.

—Will the rationale for the reserves follow the risk rule lead ultimately to the conclusion that any reserve held in respect of a policy which is not long-term, and which therefore does not fit the "legislative purpose" behind deferral of underwriting gain, must be treated as a disqualifying reserve in computing the life insurance company reserve test? *See Economy Finance Corp.* v. *United States,* 501 F.2d at 486 (fn. 7) (dissenting opinion).

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[27] Petitioner contends that "unearned premiums" need not be required by law and so are not subject to this requirement. (Pet. Br. 60 (fn. 19)). Suppose, however, that R holds $10,000 of its own life insurance reserves and, in addition, reinsures a ceding company that holds $50,000 in reserves on life insurance risks reinsured with R and $15,000 in unearned premiums on accident and health risks also reinsured with R. Will application of petitioner's "reserves follow the risk" rule result in attribution only of the unearned premiums with the result that R will fail to qualify as a life insurance company?

The results of applying the terms of Section 801 as written to this case are not absurd nor contrary to the legislative purpose. *See Commissioner* v. *Brown,* 380 U.S. 563, 571 (1965). There is nothing shocking in finding that a company that reinsures more life insurance benefits then accident and health benefits, and that maintains more life insurance reserves than accident and health insurance reserves in accordance with actuarial standards and state regulatory requirements, qualifies as a life insurance company for purposes of taxation under the Internal Revenue Code. It would be astonishing if it did not.

The reasons for refusing petitioner's invitation to rewrite the statute in the instant case are no less compelling than those given by the Court in *Commissioner* v. *Brown.* There, petitioner argued that the transfer of a business to a tax-exempt organization did not qualify as a "sale" because the risk of the business remained on the seller. The Court refused to accept that argument because:

> 1. It changed the commonly accepted meaning of the term "sale." 380 U.S. at 570-571. Similarly, petitioner now would change the meaning of the terms "unearned premiums" and "reserves" as understood not only in the insurance industry but as defined in its own Regulations, to make them fit the procrustean bed of its "reserves follow the risk" theory.
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> 2. The term "sale" is used a great many times in the Code; the Court was not prepared to accept the "wide ramifications" that the petitioner's new definition would provoke in other cases. 380 U.S. at 575. The ramifications of pe-

titioner's reserves follow the risk rule, though presumably limited to the insurance industry, would be at least as profound.

3. Petitioner's solution to the "loophole" alleged in *Brown* involved a clear case of "overkill" because it denied capital gains treatment to the *seller* in order to prevent tax-exempt *buyers* from trading on their tax exemptions. 380 U.S. at 579. In this case, petitioner's shotgun approach would disqualify a life insurance company whose principal business was reinsuring life insurance benefits in order to prevent abuses in other cases.

4. The Court ultimately concluded that it was wise policy to "leave to the Congress the fashioning of a rule which in any event must have wide ramifications." 380 U.S. at 579.[28] Given the technical and specialized provisions of the Code involved here, that policy is especially appropriate in this case.

If there are in fact any defects in the reserve test,[29] only Congress can deal with the entire subject matter comprehensively and fairly. For example, it can deal with the problem of the incomparability of life insurance reserves and unearned gross premium reserves (if the problem has not been taken care of already by the Regulations). Of equal importance, Congress can

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[28] Congress did address the problem of the bootstrap sale in a comprehensive scheme thereafter. *See* Section 514, Int. Rev. Code of 1954.

[29] In view of Congress' treatment of modified coinsurance in Section 820 it cannot be assumed that Congress would consider the present reserve test to be defective for lack of a reserves follow the risk rule.

treat with these matters on a prospective basis. It is unfair to impose the harsh penalty of disqualification from life insurance company status on companies that had no notice of the Internal Revenue Service's *ad hoc* rulemaking until after their tax returns were audited.[30]

Petitioner's own Regulations led respondent and the "several dozens of [other] companies" that have entered modified coinsurance type reinsurance agreements in past years[31] to believe that they would be judged under Section 801(a) on the basis of the reserves they actually held as reported to and accepted by state insurance authorities, and that premiums that had not been paid to them in advance would not be treated as "unearned premiums". To this very day, petitioner has not amended nor qualified those Regulations. It has never given notice of its "reserves follow the risk" rule in the Federal Register. In these circumstances, even if petitioner's new interpretation of Section 801 had merit, the Revenue Service cannot be allowed to change its position on an *ad hoc* basis to the prejudice of companies that relied on its prior interpretation of the statute. *See Vogt* v. *United States,* 537 F.2d 405 (Ct. Cl. 1976). *Cf.* 5 U.S.C. § 552(a); *Morton* v. *Ruiz,* 415 U.S. 199, 230-236 (1974); *United States* v. *Leslie Salt Co.,* 350 U.S. at 396.

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[30] Note that the consequences of disqualification can extend beyond the taxable year involved to income which was tax-deferred in several prior years. *See* Section 815(d)(2), Int. Rev. Code of 1954 which provides that if an insurance company fails to qualify as a life insurance company in two successive years, tax will be triggered on all of the tax-deferred amounts accumulated in its "policyholders surplus account" during all prior years. Thus, the tax consequences of retroactivity are much more severe than the usual tax case.

[31] See A. 175-176, 196.

III. PETITIONER MAY NOT RECAST FOR TAX PURPOSES TRANSACTIONS BETWEEN UNRELATED PARTIES HAVING SIGNIFICANT NON-TAX CONSEQUENCES.

A. Petitioner's Contention That Pilot and National Fidelity Were Merely "Paymasters" Holding Unearned Premiums "On Behalf" of Respondent is Contrary to the Court of Claims' Findings and the Facts of Record.

Petitioner concedes that this case involves "bona fide reinsurance agreements" (Pet. Br. 54, 74) between unrelated parties (A. 43), but asks that they be treated as mere agency agreements for tax purposes. That is a contradiction in terms. Pilot and National Fidelity were not "paymasters," bankers, or commission agents, as pictured in petitioner's brief, because a ceding company in a "true reinsurance agreement" pays claims and holds reserves in satisfaction of its own liabilities, as Pilot and National Fidelity did in this case, and not on behalf of the reinsurer.[32]

Respondent could not legally have entered into an agency agreement with Pilot and National Fidelity of the kind petitioner describes. It was not licensed to do business outside of Missouri and it would have been illegal for respondent to have issued policies to loan customers of Aetna or to have received unearned premiums from them, either directly or through agents. *Cf. Commissioner* v. *First Security Bank,* 405 U.S. 394 (1972).

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[32] There is a form of reinsurance, known as "assumption reinsurance", in which the reinsurer actually "steps into the shoes" of the ceding company and becomes solely liable under its policies. *See* Treas. Reg. Section 1.809-5(a)(7)(ii). However, respondent's treaties with Pilot and National Fidelity fell into the more common category of "reinsurance ceded", in which the ceding company remains solely liable to its policyholders. *See* Treas. Reg. Section 1.809-4(a)(1)(iii). *See also* Finding 19, Pet. App. 43a.

The policyholders who paid unearned premiums to Pilot and National Fidelity had contracts solely with those companies, not with respondent. Reinsurance agreements with respondent did not relieve Pilot and National Fidelity of their obligations to their policyholders; the parties took pains to point out that their agreements did not "create any right or legal relation between [respondent] and any person insured or any beneficiary under any policy of [Pilot or National Fidelity] which may be reinsured hereunder." (Exs. 4, 6, A. 44, 83, 95).

If any doubt remains as to the non-tax significance of these facts, imagine the reaction of a policyholder if he were told that one of his insurance policies with a major company was suddenly "without substance" because the policy had been reinsured, that he would have to look instead to the reinsurer with the "ultimate liability," a small company with an unfamiliar name whose capital funds were insufficient to enable it to do business in his state.

The Commissioner cannot "by manipulation of the tax law, preclude . . . [unrelated] parties from exercising business judgment as to the form in which their transactions will be cast when alternate forms have . . . disparate business and legal consequences." *Santa Anita Consolidated, Inc.*, 50 T.C. 536, 558 (1968), *acq.* 1969-2 Cum. Bull. xxv. In particular, the Commissioner may not recast the transaction into a form that would have been illegal under state law. *Commissioner* v. *First Security Bank*, 405 U.S. 394. Even where parties plan their affairs with an eye to the tax consequences, as petitioner assumes on a record that is silent as to this matter, the "fact that a transaction is so arranged that the tax consequences are highly favor-

able to one of the parties affords the Commissioner no license to recast it into one of less advantage." *Lewis & Taylor Inc.* v. *Commissioner,* 447 F.2d 1074, 1077 (9th Cir. 1971). *See Edwards* v. *Commissioner,* 415 F.2d 578, 582 (10th Cir. 1969).[33]

A contrary rule would confound business transactions. Taxpayers are and should be free to arrange their business affairs as they see fit.[34] Indeed, as a corollary of that principle, "[t]his Court has observed repeat-

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[33] The doctrine of substance over form is not usually appropriate in cases where unrelated parties have dealt at arms-length. *See* Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance,* 77 Yale L. J. 440, 469-470 (1968). Indeed, the doctrine has limits even when a sole shareholder is dealing with his own corporation. Justice (then Judge) Marshall, writing for the Second Circuit in Nassau Lens Co. v. Commissioner, 308 F.2d 39 (2d Cir. 1962) expressed the dangers of carrying the substance over form doctrine too far. "It is all very well to say that it makes little 'economic' difference whether the investment here was divided between debt and equity or was entirely allocated to equity. But by the same reasoning it may make little 'economic' difference to Pildes whether he has an unincorporated business or a corporation in which he is the sole stockholder. And if one wanted to carry the argument far enough, presumably the Commissioner would be free to make *ad hoc* attacks on a whole variety of transactions involving closely held corporations. But this Code does not so empower the Commissioner, for it recognizes and treats corporations as separate entities and affords significance to the type of investment chosen in them so long as that investment has substantial economic reality in terms of the objective factors which normally surround the type chosen." 308 F.2d at 46.

[34] *See also* Commissioner v. First Security Bank, 405 U.S. at 398-399 (fn. 4):

> "Taxpayers are, of course, generally free to structure their business affairs as they consider to be in their best interests, including lawful structuring . . . to minimize taxes. Perhaps the classic statement of this principle is Judge Learned Hand's

edly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, . . . and may not enjoy the benefit of some other route he might have chosen to follow but did not." *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974). Where, as here, the transaction is not a "sham", explainable only in terms of tax avoidance, see *Gregory* v. *Helvering*, 293 U.S. 465; *Knetsch* v. *United States*, 364 U.S. 361 (1960), taxpayers dealing at arms' length should be able to rely on the tax consequences of the route they *have* chosen to follow.

Petitioner does not allege that respondent's reinsurance agreements were "sham transactions". On the contrary, it confirms that they were "bona fide reinsurance agreements." *See*, however, Pet. Br. 62-66, discussing the *First Railroad* and *Consumer Life Insurance Company* (Treaty II) cases. Petitioner does not argue that Pilot and National Fidelity were phantom corporations like the one involved in *Gregory* v. *Helvering, supra.* It does not contend that respondent had side agreements with Pilot and National Fidelity to make the unearned premium reserves or the income therefrom available to respondent. *See Economy Finance Corporation* v. *United States*, 501 F.2d at 477. There is no common control relationship to justify spe-

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comment in his dissenting opinion in *Commissioner* v. *Newman*, 159 F.2d 848, 850-851 (CA 2 1947):

'Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich and poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.' "

cial scrutiny of the agreement between respondent and the ceding companies. *Cf. Superior Life Ins. Co.* v. *United States, supra.* In short, petitioner offers no ground whatever for disregarding the form of bona fide reinsurance agreements between respondent and unrelated ceding companies and treating them as if they were mere agency agreements.

B. Unearned Premiums Cannot Be Attributed to Respondent Under the Doctrine of Constructive Receipt.

Petitioner's brief is filled with references suggesting that respondent viewed its accident and health reinsurance agreements with Pilot and National Fidelity as a device to "shift" its non-life reserves to the ceding companies temporarily so as to qualify for life insurance company treatment.[35]

It is only petitioner that is "shifting" reserves here under its reserves follow the risk theory. Respondent never had any reserves to "shift." The parties *stipulated* that the unearned premium reserves which petitioner seeks to "shift" to respondent were actually held and invested by Pilot and National Fidelity for their own accounts; that they, not respondent, received the income therefrom; that they did not credit, set apart, or otherwise make these reserves available to respondent; and that neither respondent nor its affiliates controlled either of these companies, directly or indirectly. (A. 49-50; Finding 16, Pet. App. 39a).

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[35] There is no evidence in this case suggesting tax avoidance motives for these agreements. Even in *Economy Finance*, where the parties stipulated that there were tax reasons for using the monthly earned premium mode of payment, the Seventh Circuit found that business purposes were a "creditable motivation" for reinsuring on that basis. See *Economy Finance Corp.* v. *United States, supra*, 501 F.2d at 471.

So long as funds have not been "credited to [the taxpayer's] account, set apart for him, or otherwise made available . . .", and it is stipulated that the unearned premium reserves in this case were not, there is no basis for attribution of these reserves to respondent. *See* Treas. Reg. Section 1.451-2(a). "A bona fide contract providing for deferred payments . . . [will] be given effect notwithstanding that the obligor might have been willing to contract to make such payments at an earlier time." *Ray S. Robinson,* 44 T.C. 20, 36 (1965), *acq.* 1970-2 Cum. Bull. XXI; *Oliver G. Willits,* 50 T.C. 602, 613 (1968), *acq.* 1969-1 Cum. Bull. 21; *cf. Commissioner* v. *Oates,* 207 F.2d 711 (7th Cir. 1953); Rev. Rul. 60-31, 1960-1 Cum. Bull. 174, 178.[36]

The cases cited by petitioner to support a different result are readily distinguishable. In *Economy Finance,* the ceding company "did not even retain the right to the return on the investment of these reserves during the period of retention." 501 F.2d at 477. Both the reserves and the income therefrom were effectively in the hands of the taxpayers' stockholders in that case.

Superior Life Insurance Co. v. *United States,* 462 F.2d 945 did not involve reinsurance, the unearned premiums were held by the taxpayer's parent company, and the unearned premiums were available to the taxpayer "whenever taxpayer so desired." 462 F.2d at 950. As the Court of Claims explained below, "[s]ince the taxpayer in *Superior Life* 'constructively received'

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[36] Note that attribution was denied in these cases and rulings even though the income had already been earned by the taxpayer. That result must follow *a fortiori* where petitioner seeks to attribute premiums to respondent before they have even been earned.

unearned premiums under long-accepted principles of tax law, the Fourth Circuit's decision is entirely consistent with the fact that the existence of unearned premium [sic] depends upon the mode of premium payment." (Pet. App. 20a.)

The issue in *Commissioner* v. *Hansen,* 360 U.S. 446 (1959) was whether the taxpayers, automobile dealers, were required to *accrue* income which they had a fixed right to receive, 360 U.S. at 464; here, it is the actual receipt of premiums "paid in advance" that petitioner's Regulations regard as the critical event. Treas. Reg. Section 1.801-3(e).[37] *Hansen* also involved the Commissioner's "broad powers in determining whether accounting methods used by a taxpayer clearly reflect income," 360 U.S. at 467, while the reallocation power petitioner asserts here is not authorized by statute and is contrary to its own Regulations.

Finally, the automobile dealers in *Hansen* actually received the purchase price of their automobiles in the form of notes which they endorsed and negotiated

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[37] Indeed, attribution would not be justified here even if unearned premiums turned on the right to receive income in the future rather than actual receipt of premiums paid in advance. There is no need to accrue income until *all the events have occurred* which fix the right to receive such income. *See* Treas. Reg. Section 1.451-1 (a). Respondent had no right to receive reinsurance premiums from Pilot and National Fidelity until it had provided reinsurance coverage for a preceding month. Respondent's right in this respect was no different from the right of a landlord to receive monthly rentals for making his premises available to the tenant each month. Unless petitioner is prepared to require landlords, bankers, and others to recognize as income payments that they have a right to receive only after the income has been earned with the expiration of time and the provision of services, it should not use respondent's conditional right to receive premiums in the future as a basis for attribution of "unearned premiums".

to finance companies. It is not surprising that the dealers were required to pay tax on income from automobiles sold and paid for.[38] But the policyholders in this case were *not* respondent's customers, they did not agree to pay respondent any of their premiums, and the ceding companies (respondent's "customers") paid respondent reinsurance premiums only on a monthly basis for reinsurance provided during the previous month.

In summary, petitioner has neither the facts nor the law to justify attribution of unearned premiums from Pilot and National Fidelity to respondent in this case. Respondent's "bona fide reinsurance agreements" with the ceding companies were not agency agreements. The unearned premium reserves maintained by those companies were not credited, set apart or made available to repondent so as to justify application of the doctrine of constructive receipt. And though petitioner "shifts" reserves around as though this was a Section 482 case, that provision is inappropriate here because neither respondent nor its affiliated companies directly or indirectly controlled Pilot or National Fidelity.

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[38] *Cf.* Rev. Rul. 67-316, 1967-2 Cum. Bull. 171, holding that where an accrual basis automobile dealer receives a non-negotiable note which includes the full amount of finance charges payable over the entire term of the note, but state law requires that the unearned finance charges be refunded to the customer in the event the note is prepaid, the dealer need not take the full amount of the finance charges into income immediately but may include them ratably as earned with the passage of time.

CONCLUSION

For the reasons stated above, the judgment of the Court of Claims should be affirmed.

Respectfully submitted,

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